UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT DELAWARE

In re:	§	**Chapter 11**
	§	
NEW CENTURY TRS HOLDINGS, INC., a Delaware corporation, et al.,	§	**Case No. 07-10416 (KJC)**
	§	
	§	**Jointly Administered**
Debtors.	§	
	§	

FINAL REPORT OF MICHAEL J. MISSAL BANKRUPTCY COURT EXAMINER

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I. INTRODUCTION AND EXECUTIVE SUMMARY

On February 7, 2007, New Century Financial Corporation ("New Century," or the "Company") announced the need to restate its financial statements for the first three quarters of 2006. At the time, New Century was the second largest originator of subprime residential mortgage loans, which are loans made to borrowers who represent a high level of credit risk. The Company had grown at an incredible pace since inception, from originating $357 million in mortgage loans in its first year of operation in 1996 to approximately $60 billion in 2006. New Century's equity securities were traded on the New York Stock Exchange ("NYSE"), the Company had a market capitalization of over $1 billion in February 2007, and it had credit facilities of $17.4 billion to finance its activities. New Century reported net earnings of $411 million for 2005 and $276 million for the nine months ended September 30, 2006.

The February 7, 2007 news that New Century needed to restate its 2006 interim financial statements caused a dramatic and swift descent of the Company. Immediately following the announcement, New Century's 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 NYSE delisted the Company's securities on March 13, 2007. On April 2, 2007, New Century and many of its affiliates (collectively the "Debtors") filed for bankruptcy protection. KPMG LLP ("KPMG") resigned as the independent auditor for New Century on April 27, 2007, and the Company announced on May 24, 2007 that its financial statements for the year ended December 31, 2005 also should no longer be relied upon.

On June 1, 2007, this Court issued an order directing the United States Trustee for Region 3 ("U.S. Trustee") to appoint an Examiner to, among other things, "investigate any and all accounting and financial statement irregularities, errors or misstatements" and "to prepare a report within 90 days of the date of appointment, unless such time shall be extended by the Court." On June 5, 2007, the U.S. Trustee appointed Michael J. Missal as Examiner and that appointment was approved by this Court on June 7, 2007. On November 21, 2007, the Examiner filed his First Interim Report related to the possible post-petition unauthorized use of cash

collateral by New Century. The Court subsequently extended the date to file this Final Report until February 29, 2008.

The Examiner has completed his investigation and files this Final Report. The Examiner recognizes that the subprime mortgage market collapsed with great speed and unprecedented severity, resulting in all of the largest subprime lenders either ceasing operations or being absorbed by larger financial institutions. Taking these events into consideration and attempting to avoid inappropriate hindsight, the Examiner concludes that New Century engaged in a number of significant improper and imprudent practices related to its loan originations, operations, accounting and financial reporting processes. KPMG contributed to certain of these accounting and financial reporting deficiencies by enabling them to persist and, in some instances, precipitating the Company's departures from applicable accounting standards.

The June 1 Order required the Examiner to identify any potential claims that the Debtors' estates may have arising out of any improper conduct. The Examiner believes that at least several causes of action may be available to the estates. First, the estates may be able to assert causes of action against KPMG for professional negligence and negligent misrepresentation based on KPMG's breach of its professional standard of care in carrying out its audit and reviews of the Company's financial statements and its related systems of internal controls. Second, the estates may be able to assert causes of action against some former Officers of New Century to recover certain of the bonuses paid to them in 2005 and 2006 that were tied, directly or indirectly, to New Century's incorrect financial statements. These causes of action could seek millions of dollars in recoveries.

New Century's Officers and Directors owed the Company fiduciary duties of loyalty, due care, good faith and candid disclosure. The Examiner has assessed the conduct of certain former Officers and current and former Directors to determine whether their actions or inactions may give rise to potential causes of action on behalf of the estates. Breach of fiduciary duty claims against officers and directors have strong defenses to overcome, particularly the business judgment rule and statutory or other limitations. Accordingly, the Examiner has not included a detailed discussion of such potential claims. Nonetheless, because questions may be raised about the conduct and level of care exhibited by the former Officers and current or former Directors, some potential areas of concern are outlined in this Final Report.

All of New Century's revenues, assets and operations were directly affected by the Company's subprime lending policies and practices. It is therefore pertinent to New Century's accounting and financial reporting processes to examine issues related to the Company's loan originations.

- New Century had a brazen obsession with increasing loan originations, without due regard to the risks associated with that business strategy. Loan originations rose dramatically in recent years, from approximately $14 billion in 2002 to approximately $60 billion in 2006. The Loan Production Department was the dominant force within the Company and trained mortgage brokers to originate New Century loans in the aptly named "CloseMore University." Although a primary goal of any mortgage banking company is to make more loans, New Century did so in an aggressive manner that elevated the risks to dangerous and ultimately fatal levels.

- The increasingly risky nature of New Century's loan originations created a ticking time bomb that detonated in 2007. Subprime loans can be appropriate for a large number of borrowers. New Century, however, layered the risks of loan products upon the risks of loose underwriting standards in its loan originations to high risk borrowers. For example, more than 70% of the loans originated by the Company had low initial "teaser rates" that were highly likely to increase significantly over time. A senior New Century officer noted in 2004 that borrowers would experience "sticker shock" after the teaser rates expired. More than 40% of the loans originated by New Century were underwritten on a stated income basis. These loans are sometimes referred to as "liars' loans" because borrowers are not required to provide verification of claimed income, leading a New Century employee to tell certain members of Senior Management in 2004 that "we are unable to actually determine the borrowers' ability to afford a loan." Another common loan product offered by New Century that had a high degree of risk was the "80/20" loan, which involved two separate loans for the same transaction: a first lien mortgage loan with an 80% loan to value ratio and a second lien loan with a 20% loan to value ratio, resulting in a combined financing of 100% of the value of the mortgaged property. One Senior Officer of New Century noted in early 2006 that the performance of these 80/20 loans in 2005 was "horrendous."

- New Century also made frequent exceptions to its underwriting guidelines for borrowers who might not otherwise qualify for a particular loan. A Senior Officer of New

Century warned in 2004 that the "number one issue is exceptions to guidelines." Moreover, many of the appraisals used to value the homes that secured the mortgages had deficiencies. Of the New Century loans rejected by investors, issues with appraisals were the cause of more than 25% of these "kickouts."

- Senior Management turned a blind eye to the increasing risks of New Century's loan originations and did not take appropriate steps to manage those risks. New Century's former Chief Credit Officer noted in 2004 that the Company had "no standard for loan quality." Instead of focusing on whether borrowers could meet their obligations under the terms of the mortgages, a number of members of the Board of Directors and Senior Management told the Examiner that their predominant standard for loan quality was whether the loans New Century originated could be initially sold or securitized in the secondary market. This attitude 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. Some New Century employees recognized the increased perils of these mortgage products and lending practices starting no later than 2004, and recommended changes to manage and minimize risk. These recommendations, however, were either largely rejected or ignored by Senior Management, until market forces drove changes to the Company's practices in the second half of 2006. By that time, however, billions of dollars of dubious mortgages were either held by New Century on its balance sheet or injected into the markets.

- Senior Management was aware of an alarming and steady increase in early payment defaults ("EPD") on loans originated by New Century, beginning no later than mid-2004. The surge in real estate prices slowed and then began to decrease, and interest rates started to rise. The changing market conditions exacerbated the risks embedded in New Century's products, yet Senior Management continued to feed eagerly the wave of investor demands without anticipating the inevitable requirement to repurchase an increasing number of bad loans. Unfortunately, this wave turned into a tsunami of impaired and defaulted mortgages. New Century was not able to survive and investors suffered mammoth losses.

- Senior Management similarly gave inadequate attention to the increasing amounts of investor "kickouts." Many loans were rejected for reasons that should have been relatively easy to fix, such as missing documentation from newly funded loan files. Indeed, one former New Century manager recognized that "if we could just cure the no brainer type items I list

below we would serve ourselves well." The problem was not cured and kickout rates increased over time. Between 2004 and the end of 2006, investors rejected approximately $800 million in loans simply due to missing documentation, and billions of dollars of loans for other reasons. Investor kickouts resulted in millions of dollars in additional expenses for New Century to correct and maintain these loans, wasting New Century's assets and further impairing liquidity.

- New Century also did not invest in the necessary technologies, systems or personnel to meet its growing business and expanding challenges. Many of the Company's failures can be traced at least in part to these inadequacies.

- New Century's Senior Management did not set an appropriate "tone at the top." Many former New Century employees rationalized the Company's actions with the belief that the Company was conducting business in the same manner or even better than its competitors. The Examiner did not review the practices of other similarly situated companies, but even if New Century's practices were not outside the norm of its industry, this would not absolve anyone from failing to follow applicable accounting rules, legal standards or prudent business practices.

- New Century engaged in at least seven wide-ranging improper accounting practices in 2005 and 2006, most of which were not in conformance with generally accepted accounting principles ("GAAP"). As a whole, these practices resulted in material misstatements of the Company's consolidated financial statements for at least the fiscal year ended December 31, 2005 and the first three quarters of 2006. The Examiner did not find sufficient evidence to conclude that New Century engaged in earnings management or manipulation, although its accounting irregularities almost always resulted in increased earnings. Ironically, New Century branded itself as a "New Shade of Blue Chip," a marketing campaign which claimed that the Company would outperform its competitors by showing strong results achieved with "integrity." It is now clear that the New Century did not achieve its financial results with "integrity."

- New Century disclosed on February 7, 2007 that it had not been accounting properly for the reserve for losses associated with the repurchase of loans previously sold to investors. The Examiner's investigation determined that New Century calculated the repurchase reserve incorrectly by not accounting for the growing backlog of repurchase claims relating to older loan sales and by excluding interest that needed to be paid to investors ("Interest Recapture") at the time of loan repurchase. Specifically, New Century did not include the back-log of outstanding repurchase claims in any of its repurchase reserve calculations and excluded

Interest Recapture from the repurchase reserve calculation for 2005 and the first two quarters of 2006. The Examiner further determined that New Century reduced its repurchase reserve calculation in 2006, at a time when the Company was being flooded with repurchase claims from investors, by excluding two other critical components. In the second quarter of 2006, New Century removed a loss severity component on the existing inventory of loans already repurchased and included in the Loans Held for Sale ("LHFS") account. The Company then also removed loss severity on estimated future repurchases in the third quarter of 2006. These critical omissions and changes were a violation of GAAP and materially understated the repurchase reserve by at least $104.8 million by the third quarter of 2006. New Century also failed to apply appropriately lower of cost or market ("LOCOM") accounting in valuing LHFS. By the third quarter of 2006, the LHFS account was overstated on New Century's financial statements by at least $85.8 million.

- Several interviewees claimed that KPMG actually recommended the improper changes to the repurchase reserve calculation that were made in the second and third quarters of 2006. Although KPMG denied recommending any changes, it acknowledged discussing the issues with New Century at around the time they were made, and its workpapers document the changes. The workpapers further reflect that KPMG evaluated and approved the third quarter change. New Century is ultimately responsible for the accuracy of its financial statements, but KPMG bears responsibility, at a minimum, for suggesting accounting changes in the second and third quarters of 2006 that were inconsistent with GAAP and for failing to detect the material understatements of the repurchase reserve and the LOCOM valuation account. Further, members of the Accounting Department and KPMG should have advised the Audit Committee of these material changes to its repurchase reserve calculation, particularly since the Audit Committee specifically inquired about the adequacy of the repurchase reserve during these time periods.

- New Century failed to value properly residual interests that the Company held in off-balance sheet securitizations, which represented hundreds of millions of dollars on its balance sheet. Residual interests were New Century's rights to remaining cash flow or other assets from pools of mortgage loans the Company had securitized. New Century used flawed models to value those residual interests. The Board of Directors, Senior Management and KPMG paid close attention to the valuation of residual interests and knew that New Century was

using more aggressive assumptions, including low discount rates, in the valuation models than those of its competitors.

- If New Century had used a more appropriate discount rate to compute the present value of future cash flows, the residual interest valuations would have been reduced by at least $14.8 million as of December 31, 2005. Other flawed assumptions resulted in the further overstatement of residual interest valuations by at least another $27.5 million as of December 31, 2005. The Examiner finds that KPMG improperly acquiesced in New Century's reliance upon aggressive or stale assumptions in its residual interest valuation models. The Examiner further finds that KPMG failed to insist that New Century cure significant internal control deficiencies with respect to the valuation of residual interests, such as the absence of documentation describing how the residual interest valuation models worked and how the assumptions used in the models were established, revised or approved.

- The Examiner identified five other problematic accounting issues in 2005 and 2006 related to: (i) its allowance for loan losses ("ALL") with respect to loans it held for investment; (ii) its mortgage servicing rights ("MSR"); (iii) its deferral and amortization of loan origination fees and costs; (iv) its hedge accounting; and (v) the $77.7 million of goodwill that New Century recorded in connection with its acquisition of the loan origination platform of the prime mortgage retail division of RBC Mortgage Company. While problems associated with these accounting issues were not of the same financial magnitude as New Century's errors with regard to its repurchase reserve calculations and its valuation of residual interests, they shared some disturbing characteristics that revealed flaws in New Century's accounting and financial reporting processes.

- The problematic themes these accounting issues shared included accounting practices and/or methodologies that were inconsistent with GAAP or otherwise subject to criticism by KPMG; not documenting key assumptions underlying New Century's accounting; using discount rates in key areas of accounting that were low when compared to discount rates used by peer firms or the rates used internally by the Company when developing New Century's business plans; and dismissing or minimizing the significance of New Century's accounting errors or departures from prescribed accounting practices on grounds that they were "immaterial," even in the absence of documented support for these conclusions.

- As a consequence of these accounting failures, New Century understated its repurchase reserve by as much as 1000% 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 ("EPS") of 8% for the second quarter of 2006 as compared to the same quarter of 2005, when it should have reported at least a 40% decline in EPS. Senior Management benefited from these errors as the three founders (Robert Cole, Edward Gotschall and Brad Morrice) received financial performance bonuses in 2005 that were at least 300% more than they should have been. Other Officers received financial performance bonuses that were approximately 130% to 270% higher than appropriate.

- KPMG contributed to these failings in critical ways. Among other inadequacies, KPMG failed to question or test certain important assumptions in a rigorous manner. The KPMG engagement team acquiesced in New Century's departures from prescribed accounting methodologies and often resisted or ignored valid recommendations from specialists within KPMG. At times, the engagement team acted more as advocates for New Century, even when its practices were questioned by KPMG specialists who had greater knowledge of relevant accounting guidelines and industry practice. When one KPMG specialist persisted in objecting to a particular accounting practice on the eve of the Company's 2005 Form 10-K filing -- an objection that was well-founded and later led to a change in the Company's practice -- the lead KPMG engagement partner told him in an e-mail: "I am very disappointed we are still discussing this. As far as I am concerned we are done. The client thinks we are done. All we are going to do is piss everybody off."

- Other conduct by KPMG was equally troubling and puzzling. KPMG signed off on a New Century repurchase reserve based on the estimate that the Company would need to repurchase approximately $70 million of the loans sold in the fourth quarter of 2005. At the same time, KPMG's workpapers showed that the number of loans that New Century was going to need to purchase was approximately $140 million, not $70 million. KPMG had no explanation for this large discrepancy. Whether careless or intentional, KPMG's error contributed to a significant understatement of the repurchase reserve.

- New Century made a number of false and misleading statements in its public filings, press releases and other communications. For example, New Century disclosed in its

Form 10-K for 2005 and Forms 10-Q for 2006 that the Company "occasionally" may repurchase loans beyond the 90-day period after the loans were initially sold. These statements were misleading at best, as New Century knew it had a large and growing backlog of repurchase claims more than 90 days old, an important metric for those analyzing the Company's financial statements. The Examiner did not review all of New Century's public statements, but identified certain problematic statements in connection with the analysis of other issues.

- There was an unhealthy friction between the Board of Directors and Senior Management at a time when the business challenges would have greatly benefited from a strong collaborative relationship. An effective working relationship between a company's Board and Senior Management requires mutual respect and a healthy tension. However, this was not the situation at New Century in at least 2005 and 2006. In fact, a number of Board members were openly disdainful of certain members of Senior Management and challenged their integrity and competence. One former Director questioned whether "Management has been providing the board with full disclosure and whether Management judgments have been appropriate." That same Director further "seriously questioned" in 2005 whether "Management has been manipulating earnings." Members of Senior Management believed that some Board members were misguided and involved 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.

- New Century failed to have an effective system of internal controls. An effective system of internal controls is critical for any public company as it is required by law and promotes accurate reporting, effective operations and compliance with applicable laws and regulations. Nonetheless, New Century had a number of deficiencies in its system of internal controls, including not tracking the growing backlog of repurchase requests related to older loans sold to investors, not remediating certain control deficiencies identified in earlier audits and not having proper documentation for key financial processes. These inadequacies contributed to many of the accounting and financial reporting deficiencies identified in this Final Report. KPMG was also to blame as it did not uncover significant internal control deficiencies.

- While New Century had an active Audit Committee, it failed to focus on certain issues of crucial importance to the Company, such as loan quality issues in 2004 and 2005, ensuring a sustained analysis by Management of entity-wide risk, key operational risks and

proper supervision of New Century's Internal Audit Department. Audit Committees are a vital corporate governance gatekeeper and play an important role in assuring the accuracy and integrity of a company's accounting and financial reporting processes. Had the Audit Committee addressed these issues more effectively and with more urgency, some of the accounting and operational failures may have been avoided.

- New Century's Internal Audit Department was also deficient in a number of ways, including not giving adequate attention to kickouts and repurchase claims, and not thoroughly assessing corporate or operational risks. Because New Century was in an industry with extremely high risks, a strong Internal Audit Department was that much more crucial. Unfortunately, New Century's Internal Audit Department was not as strong a corporate governance mechanism as was needed.

The demise of New Century was an early contributor to the subprime market meltdown. The fallout from this market catastrophe has been massive and unprecedented. Global equity markets were rocked, credit markets tightened, recession fears spread and losses are in the hundreds of billions of dollars and growing. While these consequences are not the result of the activities of just one company, the lessons to be learned from New Century's failures will hopefully strengthen and improve future activities within the mortgage and financial services industries.

II. THE INVESTIGATION

A. The Appointment of the Examiner

The June 1 Order granted the motion of the U.S. Trustee for the appointment of an Examiner pursuant to 11 U.S.C. § 1104(c)(2). The June 1 Order instructed the Examiner to

> (a) investigate any and all accounting and financial statement irregularities, errors or misstatements, including but not limited to such irregularities, errors or misstatements that (i) gave rise to the announced need to restate the Debtors' financial statements for the first three quarters of 2006 and/or (ii) led the Debtors' management and Audit Committee to conclude that it was more likely than not that pre-tax earnings in the 2005 financial statements were materially overstated, and identify and evaluate any claims or rights of action that the estates might have arising from or relating to such irregularities, errors or misstatements, (b) investigate any possible post-petition unauthorized use of cash collateral by the Debtors, and (c) otherwise perform the duties of an examiner set forth in section 1106(a)(3) (as limited by this Order) and 1106(a)(4) of the Bankruptcy Code.

The June 1 Order directed the Examiner to coordinate with governmental agencies investigating matters related to New Century and the Creditors' Committee to avoid duplication of effort. The Court ordered the Examiner to file a report of his examination with the Court within 90 days of his appointment.

The Court signed an Order approving the appointment of Michael J. Missal as Examiner in this matter on June 7, 2007. Mr. Missal, a partner with the Washington, D.C. office of Kirkpatrick & Lockhart Preston Gates Ellis LLP ("K&L Gates"), engaged his firm as counsel and BDO Seidman LLP as his forensic accountants and financial advisors to assist him with respect to the examination of the Company.

B. Subsequent Orders

Given the complexity of the issues in the investigation, as well as the limitations imposed upon the Examiner as a result of delays in the production of important documents and information, the Examiner filed a Motion for an Extension of Time to File His Report with the Court on September 5, 2007. This Court granted that motion on October 10, 2007 ("October 10 Order"), and extended the deadline for the Examiner to file his report to January 15, 2008. The October 10 Order provided that, when filed, the Examiner's Report will be kept under seal for 10 days, during which time any interested party may file a motion with the Court seeking to continue to maintain any portion of the Report under seal that may be protected by 11 U.S.C. §107(b), the attorney-client privilege, the work product doctrine or any other applicable privilege or protection. The October 10 Order also provided that the production of documents to the

Examiner by the Debtors would not waive the attorney-client privilege, work product or other privileges or protections.

The October 10 Order required the Examiner to file a report on the "possible post-petition unauthorized use of cash collateral by the Debtors" upon the completion of that portion of his investigation. The Examiner filed his First Interim Report related to the cash collateral issue under seal on November 21, 2007. The Debtors filed a Motion on December 3, 2007 to maintain the seal and subsequently filed a substantive response to the First Interim Report on December 19, 2007. The Examiner filed a Limited Response on January 9, 2007. The Debtors withdrew their motion to maintain the seal with respect to the First Interim Report on January 16, 2008, and all three filings were released publicly on January 17, 2008.

The Examiner filed a Second Motion for an Extension of Time to File His Report on January 8, 2008. That Second Motion described the continued delays with respect to the scheduling of interviews of significant witnesses and production of documents. Most of those details will not be repeated here. On January 23, 2008, the Court granted the Examiner's Motion and entered an Order extending the deadline to file his Final Report to February 29, 2008.

C. Process of the Investigation

1. Issues Covered

While the mandate in the June 1 Order was broad, the Examiner did not investigate every potential issue that could have been covered by that Order. The Examiner focused his initial efforts on the two accounting issues (loan repurchase reserves and valuation of residual interests) disclosed by New Century in its Form 8-K filings on February 7 and May 24, 2007. In addition, the Examiner analyzed other significant accounting and financial statement issues that were of most significance, particularly accounting matters that relied upon critical issues, assumptions, estimates or judgments by Management and Senior Management.[1] Because many of the

[1] The Examiner refers in this Final Report to "Senior Management," which means those persons who at various times held the main leadership positions in the Company. When the Examiner refers in this Report to "Management," he is referring both to Senior Management and other persons who had significant roles in New Century's operations.

During the time that Brad Morrice was CEO (i.e., starting July 2006), the persons in Senior Management generally corresponded to the members of the Executive Management Committee ("EMC"). Prior to that time, the EMC consisted of a smaller group and Senior Management as referred to in this Report includes a group larger than the EMC.

The approximate membership of Senior Management as referred to in this Report during relevant time periods was as follows:

Company's most significant assets and liabilities were directly affected by the quality of the subprime mortgage loans it originated, the Examiner's investigation also included an overview of New Century's loan origination policies and practices and the extent to which information about loan quality problems was shared by and among the relevant areas of the Company. The investigation also included a review of matters directly related to these accounting and financial statement issues, such as the processes and practices by which New Century originated mortgage loans. Moreover, the investigation considered the roles played by various control mechanisms and gatekeepers that should have helped ensure the accuracy of the Company's financial statements, such as the Audit Committee, the Internal Audit Department, the Company's system of internal and disclosure controls and the performance of New Century's outside auditor, KPMG. The Examiner needed to review all of these matters in order to analyze whether the estates may have causes of action against any person or entity. Even though the investigation concentrated on issues related to New Century's 2005 and 2006 financial statements, some of the issues identified in this Final Report may have affected financial statements from earlier time periods.

The June 1 Order did not require a restatement of New Century's financial statements and the Examiner has not sought to undertake such a restatement. On the other hand, the Examiner has quantified the financial statement impacts of certain errors in the Company's accounting for the repurchase reserve, LOCOM valuation account, and residual interests to determine whether those accounting errors were material to the Company's 2005 and 2006 financial statements. That analysis and the underlying methodologies and assumptions are summarized in this Final Report. While the Examiner believes that these methodologies and assumptions are reasonable, he recognizes that other methodologies and assumptions could be appropriate.

The Examiner sought to assess each of the relevant issues in a thorough, objective, fair, efficient and responsible manner, without the use of hindsight. That process took a substantial amount of time and effort because the issues were complex, the process of obtaining information was slow and painstaking, and the analysis of those issues under relevant accounting and legal

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2004: Kevin Cloyd; Robert Cole; Patti Dodge; Patrick Flanagan; Edward Gotschall; Brad Morrice and Stergios Theologides.

2005: Cloyd; Cole; Dodge; Flanagan; Gotschall; Morrice and Theologides.

2006: Cloyd; Cole (until July 2006); Dodge; Joe Eckroth; Robert Lambert; Anthony Meola (May 2006); Morrice; Tajvinder Bindra (Nov. 2006) and Theologides.

standards was difficult. The Examiner has prepared a Final Report that attempts to present a fair and impartial analysis of the substantial body of information collected during the Examiner's investigation. Given the complexities of the issues this investigation has covered, and some of the obstacles the Examiner has faced, there is more that could be done to confirm relevant facts and analyze further issues that either did not arise or did not become clear until the later stages of his investigation. Nevertheless, the Examiner believes that he has gathered sufficient information to support the findings and conclusions set forth in this Final Report.

2. Obtaining Information

The examination began, as required by the June 1 Order, with the "meet and confer" held on June 14, 2007 with counsel for New Century, the Creditors' Committee and the U.S. Trustee. Consistent with the June 1 Order, the Examiner was provided information about the scope and results of the investigation that had been conducted previously by the Special Investigation Committee ("SIC") of the Audit Committee of New Century's Board of Directors.[2] At that time, O'Melveny & Myers LLP ("OMM"), counsel for the Company, led the Examiner to believe that the e-mail database created for the SIC investigation was going to be transferred promptly to the Examiner.

Subsequent to the meet and confer, the Examiner was briefed by Heller Ehrman LLP ("Heller"), counsel to the SIC, and its financial consultants, PricewaterhouseCoopers LLP ("PwC"). The Examiner sought not to duplicate the work of the SIC.

Throughout the investigation, the Examiner maintained an active and productive dialogue with counsel for the Creditors' Committee, Hahn & Hessen LLP and Blank Rome LLP. Meetings and conference calls were held regularly to ensure proper coordination and avoid duplication of efforts. The Examiner believes that these interactions were beneficial to the investigation.

a. Obtaining and Reviewing Documents

The Examiner received a large volume of documents from numerous sources throughout the course of the investigation, including: (1) New Century; (2) the SIC; (3) KPMG; and (4) several of the Company's independent Directors. As noted below, the Examiner encountered significant delays in receiving documents from both New Century and KPMG. These delays

[2] Appendix A lists many of the defined terms and acronyms used in this Final Report. Appendix B identifies many of the New Century and KPMG personnel mentioned in this Final Report.

made the review of the documents less efficient and more costly, as the Examiner's database had to be supplemented and reviewed on multiple occasions. Moreover, the Examiner received a significant number of additional documents in January 2008 from both New Century and KPMG, and the lateness of production greatly limited his review of these documents.

i. Documents Requested from New Century

The Examiner was informed initially by New Century that its employees conducted and coordinated most of their activities through the use of e-mail, much of which had already been collected for the SIC investigation. As a result, the Examiner's requests to the Company at the outset of his investigation sought primarily the mere transfer of the e-mail files of employees and officers of New Century that had been gathered for the SIC investigation. As the Examiner's investigation developed, however, the Examiner identified additional time periods and a few other custodians for which e-mail and other documents were needed. During the course of the investigation, the Examiner also learned that important electronic data were stored on several Company shared drives and requested those as well.

The Examiner made clear to New Century at the outset that, to further limit costs and burdens, the Company did not need to perform searches for specific e-mails or documents stored on the requested e-mail backup tapes or shared drives. Rather, the Examiner asked New Century simply to transfer the native electronic data files, much of which was collected prior to the Examiner's appointment. The Examiner then developed his own search terms specific to his investigation and reviewed a subset of the e-mail and documents produced by the Company.

Based on early discussions with counsel for the Debtors, the Examiner believed that there would be a relatively straightforward approach to document production. The process proved to be cumbersome and difficult, however, with inexplicable delays. The Examiner did not receive much of the electronic data he expected from New Century until the fall of 2007 and, in fact, received a substantial amount of important data in December 2007 and January 2008—long after many interviews had been conducted. Moreover, given the late dates of production, the Examiner was unable to conduct a complete review of potentially important data that likely were relevant to his investigation.

The Examiner also sought the production of certain hard copy files. Because the Company had not performed a thorough review of desk and paper files belonging to certain New Century employees, the Examiner and his counsel visited New Century's offices in early-July

2007 to review potential sources of information. After that review, the Examiner requested copies of a limited number of documents, most of which had already been organized in boxes by New Century and that could be easily duplicated. In addition, the Examiner made a small number of specific information and document requests to the Debtors as particular needs were identified. New Century substantially completed the production of the specific paper documents reviewed and requested by the Examiner and his counsel by October 2007.

The Examiner also requested easily accessible data from, or access to, several of the Company's automated accounting systems, including New Century's general ledger. Further, the Examiner asked for copies of documents from the individual computer hard drives for several key former employees.

ii. Documents Requested from KPMG

KPMG initially refused to produce voluntarily any documents or information to the Examiner. Consequently, the Examiner was compelled to seek, pursuant to Rule 2004, authority to serve one or more subpoenas on KPMG. On August 1, 2007, the Court granted the Rule 2004 Motion filed by the Examiner, and the Examiner promptly served a subpoena for workpapers and other documents upon KPMG that same day. KPMG objected to the subpoena, and the Court entered a protective order with respect to KPMG's concerns on August 21, 2007.

Counsel for the Examiner and KPMG reached resolution with respect to most of the issues relating to KPMG's production of documents to the Examiner. KPMG's production began on August 23, 2007, and, to date, the Examiner has received almost 150,000 documents (or over 1.9 million pages) from KPMG pursuant to the subpoena. More than 25% of these documents were produced after January 1, 2008, long after most of the KPMG interviews had been completed.

b. Witness Interviews

Interviews are typically an important source of information in an investigation. The Examiner and his counsel conducted approximately 110 interviews of 85 different fact witnesses. These interviews included a large number of present or former employees of New Century, as well as members of the Company's Board of Directors. Additionally, the Examiner interviewed several accountants from KPMG. The Examiner did not conduct interviews of every possible witness, but instead selected the persons believed to have the most relevant information.

There were a substantial number of delays in scheduling interviews due to both the failure to produce documents to the Examiner on a more timely basis and because a number of former senior Officers of New Century initially refused to speak with the Examiner despite being subpoenaed. Ultimately, the Examiner interviewed all persons he requested. The delays in producing documents and scheduling interviews did not allow for follow-up interviews with a number of witnesses. The investigation would have greatly benefited from such follow-up interviews.

The vast majority of witnesses appeared voluntarily for interviews by the Examiner. Most of the interviews were done in person, although some were conducted by telephone. Some potential witnesses, however, including a few former senior executives, refused to appear voluntarily, and it became necessary for the Examiner to seek subpoena authorization from the Court to conduct examinations of New Century's current and former Officers, Directors and employees pursuant to Rule 2004. The Court granted the Examiner's motion for subpoena authorization on October 16, 2007. Pursuant to that authorization, the Examiner issued Rule 2004 subpoenas to 17 individuals beginning on October 24, 2007. With one exception, these witnesses requested that the interviews not be transcribed. Notes were taken by the Examiner and his counsel at the interviews and privileged memoranda of the interviews were prepared containing mental impressions of counsel.

Many of the witnesses interviewed by the Examiner were represented by personal counsel at the interviews. To the extent a witness was still an employee of the Company, he or she was also represented by counsel to New Century. Additionally, counsel for New Century asked to attend some of the interviews of former employees of New Century whom they did not represent in order to protect the Company's privilege. The Examiner permitted counsel for the Company to attend each of those interviews.

Most of the witnesses appeared to be forthcoming in the interviews. However, several of them did not seem entirely credible, both in terms of the truthfulness of their answers and their recollections of important events. This Final Report identifies some situations where witnesses did not appear forthright.

3. Factors That Influenced the Investigation

a. Overview

The Examiner's investigation was made much more challenging, lengthy, inefficient and expensive due to some troubling failures of New Century and others to cooperate. Certain actions by New Century's counsel seemed adversarial and did not exemplify the type of cooperation that is contemplated in a bankruptcy examination. For example, the Company unreasonably withheld for many months the production to the Examiner of hundreds of thousands of important documents. Furthermore, requests for information sometimes went unfulfilled for extended periods of time.

In addition, at least one former senior New Century officer, and likely more, met with outside counsel for the Company to prepare him for his upcoming interview with the Examiner, even though New Century's outside counsel did not represent him. The Examiner informed counsel for the Company in October 2007 that he did not consider it appropriate for them to give witnesses they did not represent a preview of the Examiner's interviews as it could harm the integrity of his investigation. Counsel for the Company said that they would not do so in the future. The Examiner was also told that counsel for the Company suggested to a number of counsel for former New Century senior Officers that they could seek to challenge an upcoming production of documents by the Company to the Examiner, which could have further delayed the production of documents to the Examiner. None of the counsel for the former Officers raised any objection to the document productions. These and other actions by counsel were not within the letter or spirit of the June 1 Order directing New Century to cooperate with the Examiner.

Cooperation issues were not limited to the Debtors. KPMG did not voluntarily cooperate with the Examiner's investigation, and a number of KPMG witnesses, typically represented by five or six attorneys at their interviews, did not appear forthcoming. KPMG and its counsel further hindered the investigation by producing relevant documents related to witnesses in a manner that did not allow for the timely review before interviews were conducted.

i. Failure by New Century to Provide Accurate Information

Not only did New Century and its counsel not produce documents in a timely and efficient manner, but outside counsel to the Company provided misinformation to the Examiner about the documents collected by New Century. The Examiner was initially informed by counsel to the Debtors that the electronic documents the Debtors had collected after the

restatement announcement and used by the SIC were from approximately 80 custodians that were restored from backup tapes dating from the first quarter of 2005 to March 2007. In late-July 2007, however, New Century's counsel told the Examiner that its collection was not as comprehensive as they had represented previously. Instead, the documents collected were only from backup tapes for 25 "priority" custodians dating from the first quarter of 2006 to March 2007. For the approximately 55 remaining custodians, e-mails had not been restored from backup tapes, and the documents collected included only e-mails that existed in the custodians' e-mail inboxes when a "snapshot" was taken in either February or March 2007. As a result, the Examiner requested on August 3, 2007 that New Century restore e-mails from backup tapes both for additional custodians and for periods prior to 2006. At the same time, the Examiner also asked for electronic documents for dates subsequent to February and March 2007.

ii. Delays in Transferring E-mail Data Gathered for the SIC Investigation

Contrary to their representation at the June 14 "meet and confer" that the e-mails already collected would be produced promptly, counsel to the Company informed the Examiner in late-June 2007 that New Century and the Creditors' Committee had concerns with respect to the production to the Examiner of potentially privileged documents in the existing database without prior review by the Company. The Examiner believed that New Century had agreed to produce privileged documents regarding all issues except for some employment litigation filed after February 7, 2007. Counsel to the Company told the Examiner that New Century would identify and withhold all "potentially privileged" communications by first applying an electronic privilege filter to the data already collected and then reviewing the withheld potentially privileged documents. Given that the proposed privilege filter consisted of a long list of attorneys' names designed to gather communications with attorneys about an extremely broad group of potentially privileged subjects, counsel to New Century agreed that, if the resulting number of withheld documents was great, it would reconsider its approach.

In mid-July 2007, New Century produced approximately 1.2 million documents to the Examiner from the existing database. New Century, however, simultaneously withheld from production to the Examiner as "potentially privileged" approximately 680,000 documents, or about 40% of the then-existing database of e-mails restored from backup tapes. It appeared that the privilege filter was far too expansive, as it was highly unlikely that 40% of the communications of New Century employees were with counsel. The Examiner told counsel to

the Company that he was disappointed with the results of their approach and suggested that New Century revise the list of attorney names used to identify potentially privileged communications. Counsel for New Century agreed and said they would narrow the filter that would be applied to identify the population of potentially privileged documents.

Counsel for New Century subsequently told the Examiner that, with respect to documents dated on or before February 6, 2007 (*i.e.*, prior to the date the Company announced its planned restatement), they would design a revised privilege filter. However, counsel for the Company said that they did not have a plan in place to review any of the documents covered by that filter and would continue to withhold them from the Examiner. For documents dated February 7, 2007 and later (*i.e.*, the date of the Company's restatement announcement and later), counsel for New Century would conduct a manual privilege review with respect to prioritized custodians and would produce any documents not covered by an expanded list of issues. Aside from the documents related to the employment litigation filed after February 7, 2007, New Century also withheld privileged documents related to three other issues: the potential unauthorized use of cash collateral, communications with government investigators and the decision to declare bankruptcy. The revised privilege filter was also applied to the additional e-mail requested by the Examiner from different time periods.

At the "meet and confer" in June 2007, New Century and the Creditors' Committee indicated that they would ask the Court for an order that any information provided to the Examiner by the Company would not be viewed as a waiver of privilege. However, the issue was not pursued at the time and was not raised again until September 2007. This Court ultimately entered an Order on October 10, 2007, which provided that documents produced by New Century to the Examiner would not be deemed to be a waiver of the Company's privilege. As a result, on October 18, 2007, almost four and a half months after the start of the Examiner's investigation, New Century ultimately agreed to provide the Examiner all documents dated prior to the February 7, 2007 restatement announcement that had been withheld previously, regardless of privilege. Approximately one week later, on October 25, 2007, the Debtors began to produce the withheld documents. However, on January 11, 2008, counsel for the Debtors informed the Examiner that New Century's document vendor had failed to produce approximately 750,000 of the previously withheld documents that the Company believed it had produced to the Examiner in October 2007. These e-mails were not produced until the end of January 2008. Consequently,

the Examiner was not able to use these documents in interviews and only was able to conduct a very limited review of them.

iii. Other Document Delays

At the beginning of his investigation, New Century informed the Examiner that it did not have a centralized document management system. Instead, New Century employees tended to use e-mail to circulate documents on which they were working. Employees also used certain departmental shared drives to save documents.

Given the Examiner's sensitivity to costs and the fact that the Examiner believed New Century had already gathered the e-mails that would be relevant to the issues under investigation, the Examiner initially determined to forgo an additional request for documents from New Century's shared drives. However, as the investigation progressed, it became apparent that the documents collected by the Company did not include information that would be important to his review, such as the models used by the Company to value its assets.

Accordingly, on September 12, 2007, the Examiner requested a copy of shared drives that contained computer models and data that had been used by the Financial Reporting, Accounting, Secondary Marketing and Internal Audit Departments. The Company first provided downloads from those drives on October 15, 2007. The Examiner determined, however, that almost no models or data from the Secondary Marketing Department were provided in the October production. The Debtors confirmed that the relevant shared drives from the Secondary Marketing Department had not been produced and did not complete production from the shared drives until December 18, 2007.

Additionally, on September 12, 2007, the Examiner requested a copy of or access to Epicor, New Century's general ledger. The Debtors provided the general ledger data on September 20, but it was quickly determined that the data received were in an unusable format. The issues that prevented full access to Epicor by the Examiner were not resolved until December 2007.

b. Challenges with Respect to Documents Produced by KPMG and Interviews of Former and Current KPMG Personnel

As described above, KPMG initially refused to produce voluntarily any documents or information to the Examiner, requiring the Examiner to seek Rule 2004 authority to interview former and present KPMG personnel and to compel the production of documents. The Examiner's Rule 2004 Motion was granted on August 1, 2007, and the Examiner served a

subpoena for workpapers and other documents upon KPMG that same day. KPMG objected to the subpoena, and the Court entered a Protective Order with respect to KPMG's concerns on August 21, 2007.

After the entry of the Protective Order, counsel for the Examiner and KPMG negotiated with respect to many of the requests contained in the subpoena. When appropriate, the Examiner limited or deferred some of the requests to KPMG and agreed to accept documents from KPMG on a rolling basis.

KPMG's delays in producing workpapers, e-mails and other documents negatively impacted the Examiner's review of the relevant facts and the scheduling of interviews of current and former KPMG employees. More specifically, despite the issuance of the subpoena to KPMG on August 1, 2007 and discussions among counsel regarding the prioritization of custodians, KPMG did not begin to produce e-mails for any KPMG personnel until mid-October 2007. For several priority employees, all of whom had been identified during early discussions between counsel for the Examiner and KPMG, a large amount of their e-mails and other documents were produced during the week preceding or even after the scheduled interviews. As a result, the Examiner was forced to conduct interviews before all documents relevant to particular custodians and issues were produced or fully analyzed. Additionally, the scheduling of some of the key KPMG witnesses was delayed until December 2007 and January 2008. Further, in January 2008, KPMG produced a large amount of documents, representing approximately 25% of KPMG's total production. Although these documents may contain information relevant to the Examiner's investigation, the Examiner was only able to perform a limited review of these documents. Thus, the Examiner believes that KPMG significantly failed to cooperate in this investigation.

The lack of cooperation that the Examiner received from New Century and KPMG made the Examiner's investigation more time-consuming, expensive and inefficient. This lack of cooperation may have also succeeded in obscuring information or issues that may have confirmed, changed or supplemented the findings and conclusions in this Final Report.

III. OVERVIEW OF THE SUBPRIME MORTGAGE MARKET

In the past 30 years, the subprime mortgage industry has grown from being a relatively small portion of the overall home mortgage market to originating hundreds of billions of dollars of mortgage loans annually in recent years. The early part of this decade saw remarkable growth in the subprime mortgage industry, but in the past year or so the industry has experienced an historic collapse. A brief review of the conditions that led both to the growth of the subprime mortgage market and its recent difficulties provides context for the sections of this Final Report that follow. This section describes the origins and development of the subprime mortgage market, the factors that led to its rapid growth in the early part of this decade and the current state of the market.

A. Definition of Subprime Mortgages

The subprime mortgage market generally refers to the market for mortgage loans made to borrowers who represent a higher level of risk to the lender than borrowers who qualify for the best available (or "prime") mortgage loan interest rates. No single, commonly accepted definition exists for the term "subprime mortgage loan." Some observers have identified three categories of home mortgage loans that may broadly be classified as subprime: 1) loans to borrowers with low credit rating scores and/or poor mortgage payment histories; 2) so-called "Alt-A" mortgage loans made to borrowers whose credit scores might qualify them for prime mortgage interest rates, but who cannot or choose not to fully document the necessary asset and/or income information to obtain such rates; and 3) high loan-to-value ("LTV")[3] ratio refinance mortgages, generally originated to borrowers with relatively good credit scores.[4] Others, including federal banking regulators, classify "subprime" solely by reference to the credit characteristics of the individual borrower, and therefore do not necessarily include Alt-A and high LTV mortgage loans in their definitions of "subprime."[5] Regardless how broad or narrow a

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[3] Loan-to-value ratio refers to the ratio of the amount of the loan to the value of the mortgaged property.

[4] Kenneth Temkin, Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing*, prepared for the U.S. Dept. of Housing and Urban Development (2002), *available at* http://www.huduser.org/Publications/pdf/subprime.pdf.

[5] Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 131 at 37569-70 (July 10, 2007) ("Interagency Statement"); *Expanded Guidance for Subprime Lending Programs*, FIL-9-2001 (Jan. 31, 2001) ("Interagency Expanded Guidance"), *available at* http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf. The Interagency Statement was jointly issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift

definition, loans in the first category – to borrowers with lower credit scores – constitute the majority of subprime mortgage lending.[6]

The risk level of potential mortgage borrowers is often assessed by reference to their so-called "FICO" scores, an automated tool used by credit rating companies that assesses a variety of factors in a borrower's credit history in assessing the risk of default.[7] Though no absolute definition exists, a subprime borrower is usually one with a FICO score below the range of 620 to 660 (out of 850).[8] The interest rate charged on a subprime mortgage loan is typically around two percentage points higher than that charged on a prime mortgage loan with similar basic characteristics (e.g., loan term, fixed or variable interest rate).[9]

B. Legal and Regulatory Framework for the Development of the Subprime Mortgage Market

Before the early 1980s, the main credit available for mortgage borrowers with impaired credit or other risk factors that made them ineligible for prime mortgage loans was loans insured by either the Federal Housing Administration ("FHA") or the Department of Veterans Affairs ("VA").[10] To support liquidity in the housing finance system, Congress chartered Government Sponsored Entities ("GSE"), Fannie Mae in 1968 and Freddie Mac in 1970. Neither GSE makes

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Supervision, and the National Credit Union Administration. The Interagency Expanded Guidance document was jointly issued by all of the same agencies, except the National Credit Union Administration.

[6] *Id.* A subprime borrower has been defined as "one who has a high debt-to-income ratio, an impaired or minimal credit history, or other characteristics that are correlated with a high probability of default relative to borrowers with good credit history." Faten Sabry and Thomas Schopflocher, *The Subprime Meltdown: A Primer*, NERA Economic Consulting (June 21, 2007), *available at* http://www.nera.com/image/SEC_SubprimeSeries_Part1_June2007_FINAL.pdf. Though the common assumption is that subprime mortgage loans generally are made to "higher risk" borrowers, a recent newspaper article described an analysis of "more than $2.5 trillion in subprime loans made since 2000" that showed that "as the number of subprime loans mushroomed, an increasing proportion of them went to people with credit scores high enough to often qualify for conventional loans with far better terms." Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, *available at* http://online.wsj.com/public/article/SB119662974358911035.html. An analysis of the credit-worthiness of subprime borrowers is beyond the scope of this Final Report.

[7] The factors considered in generating a FICO score typically include the following about the borrower: bill-paying history, the number and type of accounts, whether bills are paid by the due date, collection actions, outstanding debt, and the age of accounts. *Facts for Consumers: Need Credit or Insurance? Your Credit Score Helps Determine What You'll Pay*, Fed. Trade Comm'n publication (July 2007), *available at* http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre24.shtm.

[8] Interagency Expanded Guidance, *supra* note 3.

[9] Souphala Chomsisenghphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, Fed. Reserve Bank of St. Louis Review at 34 (January/February 2006), *available at* http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf.

[10] Cathy Lesser Mansfield, *The Road to Subprime "HEL" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 480-84 (Spring 2000).

mortgage loans directly to homebuyers. Rather, each essentially helps banks, savings and loan associations and mortgage companies by buying their mortgages, packaging the mortgages into securities, which they guarantee, and then selling the securities to investors in the secondary market.[11] The idea behind these entities is to provide lenders with the capital they need to fund new mortgages, in the form of the funds obtained from the sale of loans to the GSE.

The establishment of Fannie Mae and Freddie Mac increased the liquidity available for mortgage lending generally. However, state usury laws (as well as FHA and VA restrictions regarding the mortgages they would insure) often set limits on the maximum interest rates mortgage lenders generally could charge, leading to conditions under which home mortgage credit was rationed almost exclusively to the lowest-risk, or prime, borrowers. Moreover, statutory limits on the original principal amount of loans that Fannie Mae or Freddie Mac could purchase or that FHA could insure meant that loans with higher loan balances needed to find an alternative source of funding.

The modern subprime mortgage market has its roots in the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"), Pub. L. No. 96-221, 94 Stat. 132.[12] The DIDMCA preempted state usury laws, eliminating the maximum interest rate that mortgage lenders could charge to borrowers on first lien residential mortgage loans. The DIDMCA usury preemption applied to any mortgage lender making more than $1 million of loans per year, whether the lender was a depository institution or not.[13]

Additional groundwork for the development of the subprime mortgage market was laid by the passage of the Alternative Mortgage Transaction Parity Act ("Parity Act"), Pub. L. No. 97-320, 96 Stat. 1469, in 1982. The Parity Act authorized the use of, and preempted state laws restricting, such non-traditional home mortgage products as variable interest rate loans, balloon payment loans, and negatively amortizing loans.[14] As discussed below, such products have now become common in subprime mortgage lending. Around the time the Parity Act was passed, the

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[11] This process is known as "securitization," which is discussed more fully below.

[12] Mansfield, 51 S.C. L. REV. at 492.

[13] *Id.* at 502.

[14] *Id.* at 511.

FHA also liberalized its rules for guaranteeing mortgages, thereby increasing competition in the market for certain types of mortgage loans.[15]

The final major piece of the groundwork for the growth of the subprime mortgage market came with the passage of the Tax Reform Act of 1986 ("TRA"), Pub. L. No. 99-514, 100 Stat. 2085. As part of a sweeping change to the federal income tax laws, the TRA eliminated the deduction for interest paid on consumer loans, while continuing to allow a deduction for interest paid on many home mortgages.[16] This made even relatively higher rate home mortgages, including those securing home equity loans and lines of credit, cheaper than consumer debt for homeowners, thus significantly increasing the market for credit secured by borrowers' homes.

C. Mortgage-Backed Securities and the Growth of the Subprime Mortgage Market in the Early 1990s

Even with these legal and regulatory changes, the subprime mortgage market could not have experienced the exponential growth it eventually would without the development of a strong secondary market for home mortgage loans. Loans are most commonly sold into the secondary mortgage market in one of two ways: whole loan sales and securitizations of loan pools. In whole loan sales, mortgage loan originators sell their loans, either individually or in groups or pools, to GSE and other secondary mortgage market purchasers.[17] In the process known as securitization, large numbers of mortgage loans are pooled – usually in much larger numbers than would be the case with whole loan sales, and interests in the mortgage loan pools are sold to investors. The securitized interests sold to investors are known as mortgage-backed securities ("MBS"). The holders of MBS generally receive all or some portion of the cash flow from the continuing payments on the mortgage loans in the underlying securitized pool of loans.

While MBS were previously available from the GSE, in the 1980s the credit rating agencies began rating privately-issued MBS backed by loans that were ineligible for sale to the GSE or insurance by FHA, making more MBS available for a much broader range of investors to

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[15] Edward M. Gramlich, Fed. Reserve Governor, Remarks at the Fin. Serv. Roundtable Annual Housing Policy Meeting *Subprime Mortgage Lending: Benefits, Costs, and Challenges* (May 21, 2004), *available at* http://www.federalreserve.gov/boarddocs/Speeches/2004/20040521.

[16] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 38.

[17] On its business-to-business website for use by its customers and partners in the mortgage industry, Fannie Mae describes whole loan sales as "the simplest and most straightforward type of secondary market transaction." *See* https://www.efanniemae.com/sf/exops/wls/wlsoverview/.

purchase.[18] By 1988, 52% of all outstanding residential mortgage loans were securitized, up from only 23% four years earlier.[19] The rapid expansion of the secondary mortgage market and the increased securitization of mortgage loans significantly increased mortgage lenders' access to capital, and eliminated the need for a large deposit base as a source of liquidity. This led to a proliferation of nondepository mortgage lenders. By 1989, nondepository lenders made up 32% of the market for home mortgage loans.[20]

By 1994, approximately $35 billion in subprime mortgage loans were originated annually in the United States.[21] That year, rising interest rates decreased the demand for prime mortgage loans, which in turn caused lenders to seek more aggressively to originate subprime mortgage loans.[22] In addition, technological advances enabled the collection of credit information for a broader base of borrowers, further increasing the potential market for subprime mortgage loans.[23] These developments helped spur an increase in total subprime mortgage loan originations to approximately $124.5 billion in 1997 and approximately $150 billion in 1998.[24] The 1997 total represented approximately 14.5% of total home mortgage loan originations for that year.[25] Of the $124.5 billion of subprime mortgage loans originated in 1997, approximately 53% were securitized and sold via MBS in the secondary market, up from just 28.4% only two years earlier.[26]

The growth in the subprime mortgage loan market in the 1990s was also aided by innovations in the methods of allocating or moderating risk in subprime MBS, which allowed issuers to obtain investment-grade ratings on all or part of their MBS, despite the risk in the

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[18] Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L. J. 407 (May 2007) *available at* http://www.stradley.com/articles/php?action=view&id=279.

[19] *Id.*

[20] Mansfield, *supra* note 8, at 526.

[21] Tashman, *supra* note 16, at 410.

[22] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 38.

[23] Ben S. Bernanke, Chairman, Fed. Reserve Board, Remarks at the Fed. Reserve Bank of Chi.'s 43rd Annual Conference on Bank Structure and Competition *The Subprime Mortgage Market*, (May 17, 2007) ("Bernanke Remarks"), *available at* http://www.federalreserve.gov/boarddocs/speeches/2007/20070517/default.htm.

[24] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 37.

[25] *Id.*

[26] *Id.*

subprime mortgages underlying the MBS.[27] This process is called "credit enhancement," and, by the mid-to-late-1990s, issuers began using three main methods of credit enhancement (alone or in combination):

- Senior-subordinate structures. Under this approach, pools of subprime mortgage loans are divided into "tranches," each of which has different cash flow characteristics. Specifically, certain tranches (the "senior" tranches) are paid before other tranches (the "subordinate" tranches), thus ensuring a higher credit rating for at least part of the MBS pool.
- Over-collateralization. This is a process in which the issuer puts more collateral in the pool of mortgage loans than is being sold as MBS. For example, an issuer might put $100 million of loans in a pool, and sell only $98 million of MBS. The surplus is used to ensure that the MBS can withstand losses on the underlying mortgage loans up to the amount of the surplus.
- Bond insurance. This is simply the purchase of insurance against certain losses in the underlying mortgage loan pool. In the event such losses are incurred, the insurance, provided by a third-party insurer, covers some or all of the losses, depending on the level of the coverage.[28]

As these credit enhancement innovations made more subprime MBS acceptable for a wider potential market of investors and purchasers, the total value of subprime MBS sold in the secondary mortgage market grew from $10 billion in 1991 to more than $60 billion in 1997.[29] This growth of the secondary market provided ample liquidity for nondepository and mortgage-only ("monoline") companies, which were responsible for much of the subprime mortgage lending during this period.[30]

D. The 1998 Financial Crisis and Its Impact on the Subprime Mortgage Market

By 1997, subprime mortgage lenders, with relatively easy access to liquidity in the secondary market, began originating increasingly riskier home mortgage loans. Mortgage delinquency and default rates that year were higher than had been expected.[31] Simultaneously, lower interest rates were leading to high levels of prepayments on subprime mortgage loans.[32] A

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[27] Temkin, Johnson and Levy, *supra* note 2, at 10. An investment-grade rating is important because certain types of investors, especially regulated entities such as pension funds and insurance companies, are restricted in how much they may invest in securities that do not receive such a rating.

[28] Sabry and Schopflocher, *supra* note 4, at 6.

[29] Temkin, Johnson and Levy, *supra* note 2, at 10.

[30] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 38.

[31] Temkin, Johnson and Levy, *supra* note 2, at 10.

[32] *Id.*

series of significant economic shocks, beginning in 1997, led to the first major crisis for the subprime mortgage industry. The combination of the 1997 Asian financial crisis and Russia's debt default in 1998, along with the related collapse of the Long Term Capital Management hedge fund, led to a significant decline in investors' appetite for risky investments, including subprime MBS.[33] Subprime mortgage lenders were increasingly unable to find buyers for the riskiest subprime MBS tranches, which had the dual effects of decreasing the amount of liquidity available to the lenders and saddling them with increasingly worthless assets, the book values of which they were eventually forced to write down.[34] At the same time, the large financial institutions that provided short-term credit to subprime lenders – the so-called "warehouse lenders" or "repo" providers – aware of the subprime lenders' worsening conditions, called or reduced their lines of credit to the subprime lenders, further decreasing available capital for new mortgage loan originations.[35] Reflecting these difficulties, the securitization rate of subprime mortgage loans dropped from 55.1% in 1998 to 37.4% in 1999.[36]

As a result of these issues, significant consolidation took place in the subprime mortgage lending market. Many nondepository and monoline lenders went out of business or were purchased by larger institutions with more ready access to liquidity (whether from a deposit base or through prime mortgage lending activities). By 2000, the top 25 subprime lenders by market share originated 74.1% of all subprime mortgages, up from 39.3% only five years earlier.[37]

E. The Subprime Mortgage Market Grows Again in the Early 2000s

In large part because of the difficulties described above, the aggregate total dollar value of subprime mortgage loan originations was actually lower in 2000 than in 1999.[38] However, by 2001, that number started to rise again, and it nearly doubled, from $173.3 billion to $332 billion, from 2001 through 2003.[39] By 2005, over $620 billion in subprime mortgage loans were

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[33] Sabry and Schopflocher, *supra* note 4, at 8.

[34] *Id.*; Temkin, Johnson and Levy, *supra* note 2, at 10.

[35] *Id.*

[36] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 40.

[37] *Id.* at 37.

[38] *Id.*

[39] *Id.*

originated.[40] This increase came amid a further consolidation of the industry: in 2003, the top 25 lenders originated over 93% of all subprime mortgage loans made that year.[41]

Several factors contributed to this rapid growth in originations. Low interest rates and rapid housing price appreciation provided significant incentives for first-time home purchases, as well as for homeowners to refinance their existing mortgages to access some of the built-up equity in their homes using so-called "cash-out refinancings," in which the amount of the refinancing mortgage loan is higher than the remaining unpaid principal balance of the loan being refinanced. Technological advances also contributed to the expansion of the subprime market, as lenders adopted automated underwriting processes and techniques that simultaneously sped up the mortgage loan approval process and lowered the lenders' costs of originating mortgage loans.[42]

In addition to these factors, another major factor in the subprime mortgage market's growth in the 2000 through 2006 time period was the proliferation of nontraditional mortgage products. In addition to standard fixed-rate mortgages ("FRM"), lenders began to offer an increasing array of alternative mortgage products, including:

- Adjustable-rate mortgages ("ARM"), which have a floating interest rate that adjusts periodically and is generally pegged at a specified premium above the prime interest rate (or some other published interest rate) in effect at the time the mortgage loan rate adjusts;
- Hybrid mortgages, which offer a fixed interest rate for a certain period of time (typically between two and five years), and after that adjust on a periodic basis (e.g., monthly, semi-annually or annually);
- Interest-only mortgages, which are ARM or FRM on which the borrower pays only the interest for a set period of time, after which the borrower must begin to pay down the principal; and
- Negatively amortizing loans, which are ARM or FRM on which the borrower pays less than the full, stated interest amount on the loan for a set period of time, or pays less than the amount of principal on a "normal" amortization schedule,

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[40] *Mortgage Market Turmoil: Causes and Consequences*, Before the S. Comm. on Banking, Housing, and Urban Affairs, (Mar. 22, 2007) (testimony of Sandra L. Thompson, Director, Div. of Supervision and Consumer Prot. of the FDIC) ("Thompson Testimony") *available at* http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmar22071.html.

[41] Chomsisenghphet and Pennington-Cross, *supra* note 7, at 40.

[42] Lynnley Browning, *The Subprime Loan Machine*, N.Y. Times, Mar. 23, 2007, *available at* http://www.nytimes.com/2007/03/23/business/23speed.html.

with the unpaid amount of interest and principal during that time being added to the outstanding principal balance of the loan.[43]

For the period from 2004 to 2006, of the more than three million subprime mortgage loans sold in the secondary market, approximately 45% were ARM (including hybrids), 25% were FRM, 20% were interest only loans, and 10% were negatively amortizing loans.[44] Approximately 80% of all subprime mortgage loans originated in 2005 included an adjustable rate (including interest-only and negatively amortizing ARM).[45]

Another important feature of subprime mortgage loans originated during this period was the increasing use of prepayment penalties. Prepayment penalties are used by lenders to discourage borrowers from refinancing and paying down the principal on a mortgage loan early in the loan's term. The use of prepayment penalties can be advantageous for lenders when they securitize loans for MBS, as such penalties decrease the likelihood of early refinancing of the mortgage loans in the underlying pool, thus leading to more predictability and reliability in valuing the pool's cash flow.

An important factor in the growth in the subprime mortgage market in recent years was an increasing investor appetite for subprime MBS and the greater risk inherent in, and greater return expected from, such MBS.[46] In Congressional testimony given in March 2007, the Chairman of the Federal Deposit Insurance Corporation ("FDIC") described investor demand for subprime MBS as having played a crucial role in the growth of the subprime mortgage loan industry from 2003 to 2005.[47] It is estimated that subprime MBS made up about $100 billion of the $375 billion aggregate total of all collateralized debt obligations sold in the U.S. in 2006.[48]

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[43] Sabry and Schopflocher, *supra* note 4, at 3.

[44] Yaliya Demyanyk and Yadav Gopalan, *Subprime ARMs: Popular Loans, Poor Performance*, Fed. Reserve Bank of St. Louis: Bridges, Spring 2007, at 4-5, *available at* http://stlouisfed.org/publications/br/2007/a/pages/2-article.html.

[45] Sabry and Schopflocher, *supra* note 4, at 9.

[46] *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions*; Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Serv. (Mar 27, 2007) (Testimony of Sheila C. Bair, Chairman, FDIC)("Bair Testimony") *available at* http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmar2707.html. *See also* Ellen Florian Kratz, *CSI: Subprime*, Fortune Magazine, Mar. 20, 2007, *available at* http://money.cnn.com/2007/03/19/magazines/fortune/clayton.fortune/index.htm (referring to the "voracious investor appetite" for subprime MBS as contributing to the rapid growth of the subprime mortgage loan industry in recent years).

[47] Bair Testimony, *supra* note 44.

[48] *The Subprime Lending Industry: A Look At The Restructuring of a Market in Turmoil*, prepared for ABA Annual Meeting, Bus Law Sec., Aug. 11, 2007, *available at* www.abanet.org/buslaw/newsletter/0063/materials/pp1a.pdf.

F. Current Challenges Facing the Subprime Mortgage Industry

In 2006, approximately $600 billion in subprime mortgage loans were originated in the United States, down four percent from 2005 but still nearly double the total from 2003.[49] However, originations of subprime mortgage loans were projected to have shrunk all the way down to $350 billion in 2007, a decline of 47% from 2005.[50] This decline has been caused by a variety of factors.

1. Rising Interest Rates

The Federal Reserve began raising interest rates in June 2004. The prime interest rate, which remained flat at four percent for more than a year from late-June 2003 through early-July 2004, increased to 4.25% in July 2004 and was at 5.25% by mid-December 2004. The prime rate continued to climb steadily in 2005 and 2006, going up to 8.25% by late-June 2006. The prime rate stayed at 8.25% through September 2007, when it fell, for the first time in more than four years, to 7.75%.[51] At about the same time, after years of rising relatively rapidly in many parts of the country, housing price appreciation began to slow in 2006, with the fourth quarter of 2006 having the slowest rate of annual appreciation since 1999.[52] The rate of housing price quarterly appreciation began to decrease in the third quarter of 2005, falling steadily from a rate of 3.59% in the second quarter of 2005 to 3.31% in the third quarter of 2005, 3.03% in the first quarter of 2005, 2.29% in the first quarter of 2006, 1.32% in the second quarter of 2006 and 1.03% in the third quarter of 2006, before rising slightly to 1.12% in the fourth quarter of 2006.[53] The overall economy began to cool as well during this time. This combination of factors made it difficult for borrowers to refinance mortgage loans at favorable rates, or to pay off existing mortgages by selling the mortgaged property.[54]

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[49] Thompson Testimony, *supra* note 38.

[50] Bob Ivry, *Subprime Crash Squeezes Out First-Time Home Buyers*, Bloomberg News Service, June 13, 2007, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a9WrgkMoBpyI&refer=patrick.net. Data on the total volume of subprime loans originated in 2007 was not yet available as of the date of this Final Report.

[51] *Bank Prime Loan Rate Changes: Historical Dates of Changes and Rates*, Fed. Reserve System, Nov. 2, 2007, *available at* http://research.stlouisfed.org/fred2/data/PRIME.txt.

[52] *Credit FAQ: Will Subprime Woes Spread to the Wider Mortgage Market?*, S&P Viewpoint, Mar. 13, 2007, *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,1,0,1148442756258.html.

[53] *U.S. House Price Appreciation Rate Steadies*, Office of Fed. Housing Enter. Oversight News Release, Mar. 1, 2007, *available at* http://www.ofheo.gov/newsroom.aspx?ID=375&q1=0&q2=6.

[54] Sabry and Schopflocher, *supra* note 4, at 9.

2. New Regulatory Guidance

Regulatory changes that directly impacted only federally regulated depository institutions, and related changes under some state laws, also had a chilling effect on the overall subprime mortgage market during this time period. For example, in the fall of 2006 the federal banking agencies issued guidance for nontraditional mortgage loans, including interest only loans and negative amortization loans.[55]

While the federal banking agencies' guidance described above directly applies only to banks and other financial institutions that are subject to the agencies' jurisdiction (unlike many subprime mortgage lenders), it nonetheless had a broad and chilling effect on the overall subprime mortgage market. In August 2007, the Office of Federal Housing Enterprise Oversight directed Fannie Mae and Freddie Mac, large purchasers of typically prime mortgage loans, to no longer purchase mortgage loans that did not meet the new federal guidelines.[56] In November 2006, the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") prepared guidance documents mimicking the federal guidance, and state legislatures and regulators have adopted those provisions (or substantively similar provisions) on a broad scale for the mortgage bankers and brokers they regulate. A handful of states adopted the CSBS/AARMR documents on the day they were issued, and, at this point in time, most states have, in one manner or another, adopted stringent "ability to repay" and income documentation requirements for some of the alternative mortgage products that had been a staple of subprime mortgage lender's businesses.

3. ARM Payment Delinquencies and Foreclosures

Also during this time period, a large number of hybrid ARM originated in the preceding years were reaching the point at which their interest rates reset, often to a rate at a premium above the now-higher prevailing interest rates. With the slowing economy and an often

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[55] In March 2007, the federal banking agencies, out of a concern "with so called '2/28', '3/27', and similar adjustable-rate mortgages ("ARM") that expose borrowers to significant payment shock once introductory interest rates expire," issued for public comment a draft of an "Interagency Statement on Subprime Mortgage Lending" that was issued in final form in July 2007 and "sets forth expectations for sound lending practices and clear communications with borrowers." Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 131 at 37569 (July 10, 2007) (issued by the Department of the Treasury, the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration).

[56] *OFHEO Director James B. Lockhart commends GSEs on Implementation of Subprime mortgage Lending Guidance*, Office of Fed. Housing Enter. Oversight News Release, Sept. 10, 2007, *available at* http://www.ofheo.gov/newsroom.aspx?Q1=0&Q2=0&FormMode=Detail&ID=382.

relatively large increase in monthly mortgage payments, many borrowers were unable to make their new monthly payments, leading subprime mortgage borrowers with hybrid ARM to experience large increases in payment delinquency and mortgage foreclosure rates in 2006.[57] In the fourth quarter of 2006, the payment delinquency rate was 14.4% for subprime ARM and 13.3% for all subprime mortgage loans, the highest in four years.[58] By way of contrast, only 2.57% of prime mortgages (far fewer of which are ARM) had payment delinquencies in the same period.[59] In the first quarter of 2007, the payment delinquency rate for all subprime mortgage loans rose to 13.77%, compared to only 2.58% for prime mortgage loans.[60] In the second quarter of 2007, the payment delinquency rate for subprime mortgages jumped again, to 14.82%, compared to 2.73% for prime mortgage loans.[61] In the third quarter of 2007, the payment delinquency rate for subprime mortgages increased yet again, to 16.31%, compared to 3.12% for prime mortgage loans.[62] One in every five subprime ARM loans had late payments in the third quarter of 2007, and that number does not include the one in every ten subprime ARM loans in foreclosure.[63]

Mortgage foreclosures have also risen to record highs, with 0.54% of all outstanding mortgages entering the foreclosure process in the fourth quarter of 2006.[64] The percentage of all outstanding mortgages entering the foreclosure process rose to new records of 0.58% in the first

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[57] *See* S. Comm. on Banking, Housing, and Urban Affairs (Mar. 22, 2007) (Statement of Roger T. Cole, Director, Div. of Banking Superv. and Reg., Board of Governors of the Fed. Reserve System), *available at* http://www.federalreserve.gov/newsevents/testimony/cole20070322a.htm.

[58] Douglas Dyer and Sarah Woo, *Analyzing the Subprime Market Fallout Using EDF Credit Measures*, Moody's K.M.V. Applied Research Note (Apr. 16, 2007), *available at* http://www.moodyskmv.com/research/files/wp/Research_Note_on_NEWC.pdf.

[59] Press Release, Mortgage Bankers Ass'n, *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey* (Mar. 13, 2007), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/50974.htm.

[60] Press Release: Mortgage Bankers Ass'n, *Delinquencies Decrease in Latest MBA National Delinquency Survey*, (June 14, 2007), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/55132.htm.

[61] Press Release, Mortgage Bankers Ass'n, *Delinquencies Increase in Latest MBA National Delinquency Survey*, (Sept. 6, 2007), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/56555.htm.

[62] Press Release, Mortgage Bankers Ass'n, *Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey*, (Dec. 6, 2007), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/58758.htm.

[63] *Id.*

[64] Press Release, Mortgage Bankers Ass'n, Mar. 13, 2007, *supra* note 57.

quarter of 2007, 0.65% in the second quarter of 2007 and 0.78% in the third quarter of 2007.[65] While subprime ARM represented only 6.8% of all mortgage loans outstanding in the third quarter of 2007, they represented 43% of the foreclosures started during that quarter.[66]

Many of the subprime mortgage loan payment delinquencies and defaults occurred in the first few months after the origination of the loans. The Chairman of the Federal Reserve has pointed to such EPD[67] as likely evidence that lenders loosened their underwriting standards to continue increasing loan volume when mortgage loan originations began to slow.[68] The Federal Reserve Chairman noted that "risk layering," which he defined as "combining weak borrower credit histories with other risk factors, such as incomplete income documentation or very high cumulative loan-to-value ratios," became more common at that time.[69]

The rise in EPD has had numerous adverse consequences for subprime mortgage lenders. In connection with secondary mortgage market sales (both whole loan sales and securitizations) lenders typically commit to repurchase loans under certain circumstances, including EPD. Thus, as EPD rose, many lenders were forced to repurchase loans. At the same time, investors became more reluctant to purchase subprime MBS in light of the increasingly poor performance of the underlying loans, driving total MBS issuance in 2006 down to $1.93 trillion, from a peak of $3 trillion in 2003.[70] To the extent subprime lenders were able to securitize loans, it was on conditions much less favorable to them.[71] This represented a challenge to many subprime lenders that, like New Century, were structured as Real Estate Investment Trusts ("REIT"), which are required under the federal income tax laws to return much of their cash to shareholders

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[65] Press Releases, Mortgage Bankers Ass'n, June 14, Sept. 6 and Dec. 6, 2007, *supra* notes 58, 59 and 60.

[66] Press Release, Mortgage Bankers Ass'n, Dec. 6, 2007, *supra* note 60.

[67] There is no standard definition of early payment default. Generally, the agreements between subprime mortgage loan originators and the investors to which they sold loans included a provision requiring the originator to repurchase the loans sold to the investors if the loans went into default within certain period of time after the loan sale.

[68] Bernanke Remarks, *supra* note 21, at 3.

[69] *Id. See also* Sabry and Schopflocher, *supra* note 4, at 9-10 (discussing the widespread use of "low doc" and "no doc" mortgage loans by subprime lenders).

[70] Gretchen Morgenson, *Crisis Looms in Market for Mortgages*, N.Y. Times, Mar. 11, 2007, *available at* http://www.nytimes.com/2007/03/11/business/11mortgage.html.

[71] *Subprime Mortgage Market Turmoil: Examining the Role of Securitization*, Before the Subcomm. on Sec., Ins. and Investment of the S. Banking, Housing, and Urban Affairs Comm., (Apr. 17, 2007) (Testimony of Susan Barnes, Managing Dir., Standard & Poor's Rating Services), *available at* http://banking.senate.gov/_files/ACFE4F.pdf.

every year. Because of their low level of retained cash, REIT require ready access to the secondary market to obtain the liquidity necessary to originate a high volume of mortgage loans.

4. Repurchase Demands from Warehouse Lenders

Subprime mortgage lenders have also experienced difficulties under their short-term lending arrangements with warehouse lenders. As market conditions worsened, warehouse lenders began to demand a higher fee, or "haircut," for providing short-term financing to subprime lenders to originate and purchase mortgage loans, before the securitization of those loans in MBS pools.[72] Eventually, warehouse lenders, concerned with the high level of EPD, also began to exercise their right to compel the subprime mortgage lenders to repurchase loans from the warehouse lenders, further straining the subprime mortgage lenders' available liquidity.[73]

5. The Sudden Decline in Market Conditions

The degradation of market conditions has had a significant negative impact on the viability of many subprime mortgage lenders. Reports indicate that more than 80 subprime mortgage lenders have exited the business in one way or another, including several that have sought bankruptcy protection, since the end of 2006.[74] The decline in the subprime mortgage industry has also apparently affected all mortgage lenders generally, with Reports claiming that over 200 mortgage lenders, including both subprime and prime lenders, have exited or substantially curtailed their lending businesses since mid-2006.[75] In 2007 alone, nearly 150 mortgage lenders, again including both subprime and prime lenders, were reported to have failed and gone out of business.[76]

The sudden and precipitous decline in the subprime mortgage market in the past year, and the impact of the market decline on the largest subprime mortgage lenders, is clear from a

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[72] Alistair Barr, *Big Banks Control Fate of Subprime Lenders*, MarketWatch.com, Feb. 16, 2007, *available at* http://www.marketwatch.com/news/story/big-banks-deciding-fates-troubled/story.aspx?guid=%7B08BF0083-33AD-47C7-9EDC-3AB1085BBE43%7D.

[73] *Id.*

[74] Worth Civils and Mark Gongloff, *Subprime Shakeout*, WALL ST J., *available at* http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html.

[75] The Mortgage Lender Implode-O-Meter, *available at* http://ml-implode.com.

[76] Press Release, MortgageDaily.com, *Nearly 150 Mortgage Operations Collapse in 2007* (Jan. 22, 2008) *available at* http://www.mortgagedaily.com/PressRelease012208.asp.

comparison of the identities of, and volumes of loans originated by, the top ten subprime mortgage loan originators in the second quarters of 2006 and 2007:[77]

Top Subprime Mortgage Loan Originators, Q2 2006 (dollars in millions)			
Rank	**Name** ***(bolded and italicized entities were sold or not in business by Q2 '07)***	**Location**	**Subprime Volume**
1	Wells Fargo Home Mortgage	San Francisco, CA	$27,197
2	***New Century Financial Corp.***	***Irvine, CA***	***$14,100***
3	HSBC Finance	Prospect Heights, IL	$14,061
4	Countrywide Financial Corp.	Calabasas, CA	$11,206
5	***Fremont Investment & Loan***	***Santa Monica, CA***	***$9,539***
6	***Option One Mortgage Corp.***	***Irvine, CA***	***$8,273***
7	Washington Mutual	Seattle, WA	$7,280
8	***Ameriquest Mortgage***	***Orange, CA***	***$7,200***
9	WMC Mortgage Corp.	Woodland Hills, CA	$7,100
10	***First Franklin Financial***	***San Jose, CA***	***$6,711***

Top Subprime Mortgage Loan Originators, Q2 2007 (dollars in millions)			
Rank	**Name**	**Location**	**Subprime Volume**
1	Countrywide Financial Corp. (pending sale to Bank of America)	Calabasas, CA	$5,721
2	First Franklin Financial *(sold to Merrill Lynch in early 2007)*	San Jose, CA	$5,304
3	HSBC Finance	Prospect Heights, IL	$4,707
4	Option One Mortgage Corp. *(planned sale to Cerberus Capital fell through; will now be closed)*[78]	Irvine, CA	$4,500
5	Wells Fargo Home Mortgage	San Francisco, CA	$4,106
6	Chase Home Finance	Woodcliff Lake, NJ	$3,305
7	Washington Mutual	Seattle, WA	$3,280
8	CitiFinancial	Baltimore, MD	$3,000
9	EMC Mortgage *(wholly owned subsidiary of Bear Stearns)*	Irving, TX	$2,560
10	WMC Mortgage Corp. *(a unit of General Electric)*	Burbank, CA	$1,501

[77] National Mortgage News Online, *available at* http://data.nationalmortgagenews.com/freedata/?what=bcor (last viewed on Dec. 3, 2007).

[78] Press release *H&R Block Announces Mutual Agreement To Terminate Sale Of Option One Mortgage Corporation To Cerberus Capital* (Dec. 4, 2007), *available at* http://www.hrblock.com/press/Article.jsp?articleid=1496.

As this information shows, half of the top ten in subprime mortgage loan originators in the second quarter of 2006 had either gone out of business or been sold by the second quarter of 2007 – just a year later. It is also noteworthy that each of the top ten subprime lenders in the second quarter of 2007 is either owned by a large bank or financial services company, or in the process of being acquired by a large financial institution.[79] Another analysis of the fate of top subprime mortgage lenders reported that 15 of the top 25 subprime lenders in 2006 had, by mid-2007, either shut down, been acquired or were seeking buyers.[80] The collapse of so many mortgage lenders reportedly resulted in the loss of over 86,000 jobs in the mortgage lending industry in 2007 alone, and further mortgage industry job losses are expected in 2008.[81]

Further indication of the scale and scope of the subprime mortgage crisis for subprime and other mortgage lenders comes from data about recent bankruptcy filings: four of the top five largest bankruptcy filings in the United States in 2007, measured by the amount of the debtors' pre-petition assets, were made by subprime mortgage lenders, and the fifth was a prime mortgage lender. The aggregate total of pre-petition assets reported by these bankrupt mortgage lenders was in excess of $63 billion, as shown in the following table:[82]

Mortgage Lender	Bankruptcy Filing Date	Pre-petition Assets
New Century Financial Corp. (subprime)	4/2/07	$26,147,090,000
American Home Mortgage Investment Corp. (subprime)	8/6/07	$18,828,985,000
HomeBanc Corp. (prime mortgage lender)	8/9/07	$6,822,664,000
Delta Financial Corp. (subprime)	12/17/07	$6,589,127,000
NetBank, Inc. (subprime)	9/28/07	$4,771,619,000
Total Pre-petition Assets		$63,158,485,000

The difficult conditions in the subprime mortgage industry persist as of the date of this Final Report, and government leaders and others are warning that the subprime mortgage crisis may not yet be over as millions of subprime ARM are scheduled to experience their first interest

[79] Press Release *Bank of America Agrees to Purchase Countrywide Financial Corp.* (Jan. 11, 2008), *available at* http://newsroom.bankofamerica.com/index.php?s=press_releases&item=7956. This acquisition is expected to close in the third quarter of 2008.

[80] *The Subprime Lending Industry: A Look At The Restructuring of a Market in Turmoil, supra* note 46.

[81] Jonathan Stempel, *Mortgage job losses topped 86,000 in 2007: study*, Reuters, Jan. 7, 2008, *available at* http://www.reuters.com/article/businessNews/idUSN0741649020080107.

[82] Press Release, *Number of Public Bankruptcies Slightly up in 2007, Fifth Lowest Ever, According to BankruptcyData.com* (Jan. 16, 2007), *available at* http://www.businesswire.com/portal/site/home/index.jsp?epi_menuItemID=887566059a3aedb6efaaa9e27a808a0c&ndmViewId=news_view&ndmConfigId=1008918&newsId=20080116006169&newsLang=en.

rate reset by the end of 2008.[83] In an effort to keep the subprime crisis from expanding when those ARM rates reset, the federal government has worked with lenders and others in the mortgage industry to develop a program, announced on December 6, 2007, to freeze interest rates on some subprime ARM for five years and to provide a framework to facilitate the refinancing or modification of subprime ARM.[84] In addition, several pieces of legislation have been introduced in Congress in response to the subprime mortgage crisis, including a bill that would enable the FHA to serve more subprime borrowers[85] and a bill that would give bankruptcy judges the power to change the mortgage terms for the primary residences of bankrupt homeowners.[86]

As the media indicates on a regular basis, the shockwaves of the crisis in the subprime mortgage industry have been felt and continue to ripple throughout the credit, stock, financial, real estate and other markets in the United States and abroad.

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[83] Hearing Before the Joint Econ. Comm. of the U.S. Congress (Nov. 8, 2007) (Testimony of Ben S. Bernanke, Chairman, Fed. Reserve Board), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20071108a.htm.

[84] For more information on this program, see the *Statement by Secretary Henry M. Paulson, Jr. at Press Conference to Announce Framework to Help Preserve Communities by Preventing Foreclosure*, Dec. 6, 2007, *available at* http://www.treasury.gov/press/releases/hp716.htm, and the American Securitization Forum's *Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans*, Dec. 6, 2007, *available at* http://www.americansecuritization.com/story.aspx?id=2174.

[85] Expanding American Homeownership Act of 2007, H.R. 1852, passed by the House and referred to the Senate on Sept. 19, 2007.

[86] Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, introduced Sept. 20, 2007.

IV. BACKGROUND OF NEW CENTURY

A. Overview

New Century Financial Corporation was founded in 1995.[87] New Century originated, retained, purchased, sold and serviced home mortgage loans, primarily first mortgage loans, on a nationwide basis.[88] At one time, the Company was the second largest subprime mortgage lender in the United States, measured by loan production volume,[89] and employed over 7,200 people.[90] By the end of 2006, the Company was the third largest subprime mortgage loan originator in the United States, with a loan production volume that year of $51.6 billion.[91] On February 7, 2007, New Century announced that it would need to restate its financial statements for the first three quarters of 2006 because of errors in accounting for losses related to its mortgage loan repurchase obligations.[92] On March 2, 2007, New Century reported that it would be unable to file timely its Annual Report on Form 10-K for 2006.[93] On April 2, 2007, New Century filed its Chapter 11 bankruptcy petition in this Court. On May 24, 2007, New Century reported that its 2005 pre-tax earnings had been materially overstated and that the Company's 2005 financial statements should no longer be relied upon.[94]

The following subsections provide a brief history of New Century from its founding in 1995 through 2004, and a summary of New Century's business strategies, operations, financial performance, risk exposures, Management and significant developments since 2004.

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[87] Declaration of Monika L. McCarthy in Support of Ch. 11 Petitions and First Day Relief, signed Apr. 2, 2007 ("McCarthy Declaration") at 2, para. 3.

[88] *Id.*

[89] New Century's Form 10-K for 2004 at 4. All subsequent references below to Forms 10-K, Forms 10-Q and Forms 8-K and other SEC filings are to New Century's filings.

[90] Form 10-K for 2005 at 21; Annual Report to Shareholders for 2005 at 10, *available at* http://media.corporate-ir.net/media_files/irol/73/73989/reports/NEW2005AR.pdf.

[91] S&P Viewpoint, *Subprime Mortgage Lenders: Transition in a Stressed Mortgage Cycle*, May 8, 2007, *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1148444105578.html

[92] Form 8-K, Feb. 7, 2007, Item 4.02.

[93] Form 12b-25 (Notice of late filing of Form 10-K for 2006), Mar. 2, 2007.

[94] Form 8-K, May 24, 2007, Item 4.02.

B. Brief History of New Century from Its Founding through 2004

1. Company Founding, Operations and Growth

New Century was founded as a Delaware corporation in 1995 by Brad Morrice, Edward Gotschall and Robert Cole.[95] It ended 1996, its first full year of operation, with over 300 employees and an annual mortgage loan production volume of over $350 million.[96] The Company became a public company in June 1997, trading on the NASDAQ.[97] By 2001, New Century had originated over $20 billion in mortgage loans since its inception[98] and had approximately 1,500 employees.[99] In 2002, New Century originated over $14 billion in mortgage loans.[100] By 2003, New Century employed over 3,700 people and originated over $27 billion in mortgage loans.[101] Also in 2003, New Century restructured its business and began retaining 20 to 25% of its mortgage loan production on its balance sheet by structuring loan securitizations as financings rather than as sales.[102]

The following excerpt from the general business description at the beginning of New Century's Annual Report on Form 10-K/A for 2003 summarizes the Company's business model throughout the period from its founding through 2004:[103]

> We offer mortgage products designed for borrowers who generally do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. We originate and purchase loans on the basis of the borrower's ability to repay the mortgage loan, the borrower's historical pattern of debt repayment and the amount of equity in the borrower's property (as measured by the borrower's loan-to-value ratio, or LTV). We have been originating and purchasing these types of loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to

[95] Form 10-K for 2005 at F-11.

[96] Form 10-K405 for 1997 at 32, F-6.

[97] Form 10-K405 for 1997 at 24.

[98] Form 10-K for 2001 at 38 (noting the Company originated and purchased $6.2 billion in loans in 2001 and $4.2 billion in 2000); Form 10-K for 1999 at 34 (noting the Company originated and purchased $4.1 billion in loans in 1999 and $3.3 billion in 1998); Form 10-K405 for 1997 at 30 (noting the Company originated $2.0 billion in loans in 1997 and $356.9 million in 1996).

[99] Form 10-K for 2001 at 21.

[100] Form 10-K for 2002 at 2.

[101] Form 10-K for 2003 at 1, 23.

[102] Form 10-K for 2005 at 56; Form 10-K for 2003 at 14.

[103] Form 10-K/A for 2003 at 1.

effectively manage the potentially higher risks associated with this segment of the mortgage industry.

The rapid growth of New Century in the first four years following its founding in 1995, and then especially from 2001 through its conversion to a REIT structure in 2004, is illustrated by the following key data from the Company's Annual Reports on Forms 10-K filed for the years from 1997 through 2004 (dollars in thousands):[104]

Year	Full-time Employees	Total Revenue	Assets	Loan		
				Originations and Purchases	Securitizations	Sales (whole loan)
1996	300+	$14,505	$4,413	$356,939	$0	$298,713
1997	1,140	$98,633	$398,128	$1,964,601	$1,123,618	$617,182
1998	1,404	$176,407	$624,727	$3,324,856	$2,265,700	$1,477,225
1999	1,740	$233,942	$863,709	$4,080,264	$3,017,658	$1,033,006
2000	1,485	$163,916	$837,161	$4,152,357	$1,029,477	$3,133,205
2001	1,512	$293,336	$1,451,318	$6,244,971	$898,244	$4,723,350
2002	2,468	$606,246	$2,402,928	$14,201,496	$845,477	$12,419,687
2003	3,725	$975,966	$8,934,880	$27,382,838	$4,946,781	$20,835,105
2004[105]	5,200	$1,732,567	$19,051,944	$42,199,640	$10,111,131	$30,329,278

As described in more detail above, the entire subprime mortgage industry grew rapidly during the period from 2001 to 2005, with the dollar amount of subprime mortgage loans originated nearly quadrupling during that time period, from $173 billion to more than $620 billion. New Century's subprime mortgage loan originations and purchases during the same time period increased more than nine-fold, from $6.2 billion in 2001 to $56.1 billion in 2005.[106]

New Century's asset and liability structure during the period from 2000 through 2004 was as follows (dollars in thousands):[107]

[104] Data is from Forms 10-K or Forms 10-K/A filed by New Century for each of the years 1997 through 2004 (data for 1996 is from the Form 10-K for 1997).

[105] The "Total Revenue" amount for this year is the sum of interest income and all other operating income.

[106] Form 10-K for 2001 at 34; Form 10-K for 2005 at 54.

[107] Data is from New Century's Forms 10-K for 2000 through 2004.

Balance Sheet Item (year-end)	Year				
Assets:	**2004**	**2003**	**2002**	**2001**	**2000**
Cash & Cash Equivalents[108]	$842,854	$278,598	$176,669	$100,263	$10,283
Restricted Cash[109]	$454,035	$116,883	$6,255	$6,416	--
Mortgage Loans HFS[110]	$3,922,865	$3,422,211	$1,920,396	$1,011,122	$400,089
Mortgage Loans HFI[111]	$13,195,324	$4,745,937	--	--	--
Residual Interests[112]	$148,021	$179,498	$246,964	$306,908	$361,646
Liabilities:					
Credit Facilities on LHFS[113]	$3,704,268	$3,311,837	$1,885,498	$987,568	$404,446
Financing on LHFI[114]	$13,105,973	$4,686,323	--	--	--
Convertible Senior Notes	$5,392	$204,858	--	--	--
Subordinated Debt	--	--	--	$40,000	$40,000
Residual Financing	--	--	--	$79,941	$176,806
Other Liabilities	$357,746	$198,909	$130,880	$96,048	$63,760

As this information shows, starting in 2003 New Century began holding on its balance sheet a substantial amount of loans for investment, with corresponding financing (which was largely in the form of securitized bonds known as Real Estate Mortgage Investment Conduit, ("REMIC") and Collateralized Mortgage Obligation, ("CMO") issued in the loan securitization process).[115]

2. New Century's 2004 Conversion to a REIT Structure

In 2004, New Century's Board of Directors approved a plan to change the Company's corporate structure to allow it to qualify as a REIT for U.S. federal income tax purposes.[116] This

[108] "Cash equivalents" were considered by the Company to include "all highly liquid debt instruments with original maturities of three months or less." Form 10-K for 2004 at F-11.

[109] "Restricted cash" included "cash held in various margin accounts associated with the Company's interest rate risk Management activities," "cash held in custodial accounts associated with [the Company's] mortgage loans held for investment," and "cash held in a cash reserve account in connection with [the Company's] asset-backed commercial paper facility. *Id.*

[110] "HFS" means "Held for Sale."

[111] "HFI" means "Held for Investment."

[112] As discussed in more detail below, "residual interests" refers to amounts recorded as an asset by New Century "as a result of the sale of loans through securitizations that the Company structures as sales rather than financings." *Id.* at F-12.

[113] "LHFS" means "Loans Held for Sale."

[114] "LHFI" means "Loans Held for Investment."

[115] Form 10-K for 2005 at F-33.

[116] *Id.* at 1.

structure results in the REIT entity owing little to no corporate income taxes, though the income of New Century's taxable subsidiaries remained fully taxable.[117] To maintain its status as a REIT, New Century was required to distribute at least 90% of the REIT's annual, taxable income to its shareholders.[118] Accordingly, this structure limited the Company's ability to accumulate capital for mortgage lending operations.[119]

To accomplish the Company's restructuring to a REIT, New Century Financial was formed as a Maryland corporation, and the existing Delaware corporation, New Century TRS, merged with and into a wholly-owned subsidiary of New Century Financial.[120] The merger was completed in October 2004.[121] The parent corporation, New Century Financial Corporation, was listed on the (NYSE)[122] and succeeded to and continued to operate substantially all of the existing business of New Century TRS and its subsidiaries.

New Century ended 2004 with an annual mortgage loan production volume of over $42 billion.[123]

C. New Century's Financial Performance and Business Strategies and Operations After 2004

1. Overview of Financial Performance and Growth

New Century's reported financial performance and growth from its REIT conversion in 2004 through 2005 and into 2006 were strong. The Company's growth and financial performance during that time is illustrated by the following key data:[124]

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[117] *Id.* at 22, 65-66.

[118] Form 10-K for 2005 at 27, 46, F-36.

[119] Form 10-K for 2004 at 58; Form 10-K for 2005 at 46.

[120] *Id.* at F-10.

[121] *Id.*

[122] *Id.* at 2-3, F-11.

[123] *Id.* at 17, 79.

[124] Form 10-K for 2004 at 25; Form 10-K for 2005 at 21, 54, F-6, F-7; Form 10-Q for Q3 2006 at 1, 2, 44.

Year	Full-time Employees	Gross Income[125]	Net Earnings	Assets	Loan		
					Originations and Purchases	Securitizations[126]	Sales (whole loan)
2004	5,200	$1,732,567	$375,571	$19,051,944	$42,199,640	$10,111,131	$30,329,278
2005	7,200	$2,443,098	$411,125	$26,147,090	$56,108,241	$17,403,859	$35,314,781
2006 Q3[127]	7,119	$ 684,240	$267,613	$25,059,768	$45,443,272	$ 3,393,531	$41,144,687

The principal components of New Century's revenues during this time frame were interest income from mortgage loans held for investment or held pending sale, and gains recognized from whole loan sales and securitizations structured as sales.[128] In 2005, the Company's net interest income increased to $771.4 million from $531.5 million in 2004, primarily as a result of higher average balances of mortgage loans held for investment and held for sale. The increase in mortgage loans held for investment in 2005 resulted from higher overall loan production coupled with the strategy, previously noted, of retaining approximately 20% to 25% percent of loan production on the Company's balance sheet.[129] During 2005, New Century also reported $622.6 million in gain on whole loan sales and securitizations structured as sales (net of associated expenses).[130]

Another source of revenue for New Century came from servicing the mortgage loans it originated and purchased. Mortgage loan servicing generally involves receiving monthly payments from borrowers and disbursing the payment proceeds to the appropriate parties, notifying borrowers when payments are late, dealing with payment defaults and foreclosures, and working with borrowers to answer questions and resolve issues that arise during the life of a mortgage loan.[131] Since 2001, New Century had generated revenue either by selling the servicing rights as part of the whole-loan sales or securitizations or by selling servicing rights

[125] "Gross Income" as used in this table is the sum of the Company's reported gross interest income and gross other operating income.

[126] "Securitizations" as used in this table includes both securitizations structured as sales and securitizations structured as financings.

[127] The Company's financial data was last disclosed for the third quarter of 2006. As discussed above, New Century announced previously that it determined it could not file a Form 10-K for 2006 without unreasonable effort and expense.

[128] Form 10-K for 2005 at F-7.

[129] Form 10-K for 2005 at 69, F-7.

[130] Form 10-K for 2005 at F-7, F-25.

[131] Form 10-K for 2005 at 12; *see also* McCarthy Declaration at 5, para. 12.

that had been retained by New Century to another loan servicer.[132] In more recent years, and particularly since 2004, the Company increasingly sought to retain the servicing rights to mortgage loans it originated, and New Century generated revenue by collecting fees for servicing the loans.[133] The Company's servicing income totaled $28.9 million in 2004, $38.5 million in 2005 and $47.4 million by the end of the third quarter of 2006.[134]

By 2005, New Century's reported assets had grown more than tenfold from 2002, from $2.4 billion to $26.1 billion, reflecting the Company's overall growth as well as the strategy shift beginning in 2003 to keeping a substantial loan portfolio on the Company's balance sheet.[135] Thus, in 2005, out of total assets of $26.1 billion, New Century reported $16.1 billion in mortgage loans held for investment.[136]

When New Century completed a mortgage loan securitization that was structured as a sale rather than a financing, it booked on its balance sheet the residual economic interest retained by the Company.[137] The residual interest represented the present value of the future cash flows the Company expected to receive from the residual interest.[138] In 2004, New Century did not complete any securitizations structured as sales.[139] In 2005, New Century completed four securitizations structured as sales worth $11.0 billion, recognized gain of $141.5 million on these transactions, and retained residual interests that the Company valued at $97.5 million.[140] In total, in 2005, New Century reported $234.9 million in residual interests in securitizations on its balance sheet.[141] During the nine months ended September 30, 2006, the Company did not complete any securitizations structured as sales, and it reported $223.7 million in residual interests on its balance sheet at September 30, 2006.[142] New Century said it valued its residual

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[132] Form 10-K for 2004 at 16-18.

[133] Form 10-K for 2005, p. 37-38.

[134] *Id.* at 72; Form 10-Q for Q3 2006 at 2.

[135] Form 10-K for 2005 at 53.

[136] *Id.*

[137] Securitizations that are structured as sales rather than financings are referred to as "off-balance sheet" securitizations. Form 10-K for 2005 at 64.

[138] Form 10-Q for Q3 2006 at 9-10.

[139] Form 10-K for 2005 at F-28.

[140] *Id.* at 11.

[141] Form 10-K for 2005 at F-6.

[142] Form 10-Q for Q3 2006 at 14.

interests in its off-balance sheet securitizations by estimating the future rate of prepayment, the prepayment premiums it expected to receive, and the manner in which expected delinquencies, defaults and default loss severity were expected to affect the amount and timing of cash flows.[143]

New Century's reported asset and liability structure during the period from 2004 through 2006 was as follows:[144]

Balance Sheet Item (at period end)	**Year**		
Assets:	**2006 Q3**	**2005**	2004
Cash and Cash Equivalents	$408,860	$503,723	$842,854
Restricted Cash	$572,847	$726,697	$454,035
Mortgage Loans Held for Sale	$8,945,134	$7,825,175	$3,922,865
Mortgage Loans Held for Investment	$14,030,999	$16,143,865	$13,195,324
Residual Interests in Securitizations	$223,680	$234,930	$148,021
Other Assets[145]	$878,248	$712,700	$488,845
Liabilities:			
Credit Facilities on Mortgage LHFS[146]	$8,487,850	$7,439,685	$3,704,268
Financing on Mortgage LHFI[147]	$13,858,940	$16,045,459	$13,105,973
Convertible Senior Notes	--	$4,943	$5,392
Junior Subordinated Notes	$51,545	--	--
Other Liabilities[148]	$597,084	$547,303	$357,746

As described above, as the housing market began to slow in 2006, subprime mortgage loan delinquencies and foreclosures increased as subprime borrowers—who had been able previously to take advantage of housing price appreciation and increased home equity by either refinancing or selling their homes—began defaulting on their loans in increasing numbers.[149]

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[143] *Id.* at 11.

[144] *Id.* at 1; Form 10-K for 2005 at F-6.

[145] "Other Assets" includes mortgage servicing assets, real estate owned, accrued interest receivable, net income taxes, office property and equipment, goodwill and prepaid expenses.

[146] "LHFS" means "Loans Held for Sale."

[147] "LHFI" means "Loans Held for Investment."

[148] "Other Liabilities" includes accounts payable and accrued liabilities and notes payable.

[149] *See* House Prices and Subprime Mortgage Delinquencies, Fed. Reserve Bank of S.F. Econ. Letter at No. 2 2007-14, at 2 (June 8, 2007), *available at* http://www.frbsf.org/publications/economics/letter/2007/el2007-14.pdf; Bernanke Remarks, *supra* note 21 ("In the fourth quarter of 2006, about 310,000 foreclosure proceedings were initiated, whereas for the preceding two years the quarterly average was roughly 230,000. Subprime mortgages accounted for more than half of the foreclosures started in the fourth quarter. . . . For [adjustable rate subprime] mortgages, the rate of serious delinquencies--corresponding to mortgages in foreclosure or with payments ninety days or more overdue--rose sharply during 2006 and recently stood at about 11 percent, about double the recent low seen in mid-2005."), *see also* McCarthy Declaration at 10-11, paras. 37-39.

Additionally, increases in interest rates negatively impacted consumer demand for mortgage products.[150]

Nonetheless, during 2006 New Century reported positive financial results. On May 4, 2006, New Century reported "strong first quarter 2006 results highlighted by a 21% growth in earnings per share ("EPS"), a 17% increase in REIT taxable income, and 31% growth in mortgage loan production compared with the same period last year."[151] On August 3, 2006, New Century reported second quarter net earnings of $1.81 per share—an 11% increase over the second quarter of 2005—and trumpeted its second quarter results as "evidence of the strength and stability of our franchise."[152]

On November 2, 2006, New Century released its financial results for the nine months ending September 30, 2006. The Company noted the "challenging" market environment, but reported that its "operating results were solid" excluding the impact of certain hedging-related accounting charges.[153] New Century highlighted that loan production volume was comparable to the previous quarter and that the Company had achieved record low loan acquisition costs.[154] Return on assets on the Company's loan portfolio held for investment was reported to have increased over the second quarter before the impact of hedging-related activities.[155] Further, New Century reported that a higher loan delinquency rate in its portfolio was attributable to "normal portfolio seasoning," and that the Company was "adequately reserved for the expected higher level of loan losses."[156] New Century also reported that its gain-on-sale of loans declined in the third quarter in part due to higher levels of loan repurchases and steeper discounts on discounted loan sales.[157] Although New Century's reported EPS of $1.12 reflected a decline compared to both the third quarter of 2005 ($2.04) and the second quarter of 2006 ($1.81), the

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[150] Form 10-Q for Q3 2006 at 39; *see also* McCarthy Declaration at 10-11, paras. 37-39.

[151] Earnings Release for May 4, 2006.

[152] Earnings Release for Aug. 3, 2006.

[153] Earnings Release for Nov. 2, 2006; Form 10-Q for Q3 2006 at 39-41.

[154] *Id.*

[155] *Id.*

[156] *Id.*

[157] *Id.*

Company noted that $0.75 of this decline was attributable to the marking-to-market of derivatives that did not qualify for hedge accounting treatment.[158]

2. New Century's Corporate Culture

Like other subprime mortgage lenders, and most if not all other types of businesses, the corporate culture at New Century generally appears to have been one that focused on and encouraged production, sales and growth. Another apparent aspect of New Century's corporate culture was the notion that the Company was "better than" its competitors. This attitude may be reflected somewhat in New Century's disclosure of its "Competitive Advantages" in its Forms 10-K for 2004 and 2005. In those filings, New Century listed the following "competitive strengths":[159]

- One of the largest mortgage REIT portfolios [2004 and 2005].
- One of the largest taxable REIT subsidiaries [2004].
- Lower-cost portfolio accumulation strategy [2004].
- Operational flexibility [2004 and 2005].
- Long-standing institutional relationships [with loan buyers and warehouse lenders]; [2004 and 2005].
- Automated credit grading capability [2004 and 2005].
- Reputation for high quality customer service [2004 and 2005].
- Management experience and depth [2004 and 2005].
- Leading mortgage loan origination franchise [2005].
- Low-cost producer [2005].

New Century's "better than the competition" attitude also seems to be evident in the Company's adoption and use of a branding initiative in 2005: "New Century Financial – A New Shade of Blue Chip." A press release announcing the launch of this branding initiative said:[160]

> "Blue chip" is synonymous with companies known as quality investments that deliver long-term value for stockholders and are entrenched leaders in their industries. In addition, "blue chip" connotes strong performance and stability. Like traditional blue chip companies, New Century Financial has outperformed its competitors with consistent and strong financial performance. As a "New Shade

[158] *Id.*

[159] Form 10-K for 2005 at 4.

[160] Press Release, *New Century Financial Corporation Announces Launch of First Corporate Branding Initiative* (Feb. 7, 2005) *available at* http://investorrelations.ncen.com/phoenix.zhtml?c=73989&p=irol-newsArticle_Print&ID=671067&highlight=.

of Blue Chip," New Century will update the traditional view of a "blue chip" company by emphasizing not only strong results, but also how those results are achieved.

3. New Century's Business Strategies

New Century reported in its Form 10-K for 2004 that its "business objective is to provide a stable and growing dividend to our stockholders by growing and managing a portfolio of mortgage related assets."[161] The Company said it intended to "execute this strategy" by doing the following:

- Building our portfolio of mortgage-related assets.
- Actively managing our mortgage loan portfolio.
- Maintaining a strong capital and liquidity base.
- Expanding our servicing platform.
- Strengthening our [loan] production franchise.
- Developing and growing new mortgage products.

In its Form 10-K for the following year, 2005, New Century's stated business objective remained essentially the same—"deliver an attractive return to our stockholders, including a stable dividend"—but there was somewhat less emphasis on growing the Company's mortgage loan portfolio. In its Form 10-K for 2005, New Century said it would achieve its objective by:

- Delivering consistently strong operating performance, including taxable REIT subsidiary ("TRS") and mortgage loan portfolio earnings.
- Broadening the mortgage products and services available through each of our delivery channels.
- Increasing productivity while reducing costs to enhance our competitive position in the industry.
- Actively managing our mortgage loan portfolio.
- Maintaining a strong capital and liquidity base.

It appears that, within a year or so after its conversion to a REIT in October 2004, a divide began to develop within New Century's Board of Directors and between some members of the Board and the Company's Management regarding the appropriate business strategy for the Company. Some felt that the Company should, like other REITs, pursue a "portfolio" strategy in which mortgage loans would be originated and held by the Company, including through loan

[161] Form 10-K for 2004.

securitizations that remained on the Company's balance sheet. Others were critical of the portfolio 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 its balance sheet.

Differences of opinion also existed within the Board of Directors and between it and New Century's Senior Management with respect to dividend and liquidity policies and issues, with some favoring large dividends that reduced the Company's liquidity and others favoring lower dividends and higher liquidity. Related to the liquidity issue, the Board also had differences of opinion regarding repurchasing the Company's stock to increase its stock price.

Through the first half of 2006, the debate among New Century's Board of Directors and Senior Management regarding the appropriate financial strategy for the Company appears to have consisted of three general positions: (1) use free capital to repurchase stock and stop securitizing loans; (2) use free capital to grow the REIT portfolio; and (3) use free capital to bolster liquidity. Morrice, the Company's Chief Executive Officer ("CEO"), said in his interview with the Examiner that this debate recurred at every Board of Directors meeting in the first half of 2006. The minutes of the June 28 and 29, 2006 meeting of New Century's Board of Directors indicate that, at that meeting, the Board ended the debate and determined that New Century was a mortgage banking company with a REIT overlay that could use securitizations as a tool, instead of a REIT that focused on securitizations and also happened to originate mortgage loans.[162] According to people interviewed during the Examiner's investigation, this was the point at which the Board and Senior Management reached an agreement as to the fundamental nature of the Company. As a consequence of this decision, New Century stopped securitizing and adding loans to its portfolio in the second half of 2006. The strategy of originating and selling loans had prevailed over the portfolio strategy.

The Company described its shifts in business strategy, first to holding loans on its balance sheet in 2003, and then away from that to selling loans in 2006, as follows:[163]

> During 2003, we shifted our strategy to hold loans on our balance sheet. . . . During the third quarter of 2006, we chose to sell loans in the whole loan market

[162] The minutes of a June 12, 2006, telephonic meeting of the Finance Committee meeting state: "Mr. Morrice reported that the members of the EMC [Executive Management Committee] had determined that mortgage banking is the Corporation's core business." The minutes of the June 28 and 29, 2006, meeting of the New Century Board of Directors state that "[t]he meeting participants then discussed the belief that the Corporation is fundamentally a mortgage banking company that happens to own a portfolio and utilize a REIT structure."

[163] Form 10-Q for Q3 2006 at 40.

> rather than adding assets to our REIT portfolio, resulting in a decline in the portfolio balance. Going forward, we will continue to evaluate the relative advantages and disadvantages of whole loan sales versus securitizations, taking into account secondary market conditions and our capital allocation strategy.

After the determination was made to pursue the "originate and sell" strategy, the Board and the Finance Committee had discussions regarding potentially "running off" or selling New Century's loan portfolio and effectively "de-REITing," because if New Century no longer had a loan portfolio it could not be a REIT. The Board ultimately did not make a decision by the end of 2006 regarding "de-REITing," and subsequent events like the restatement announcement obviously overtook that issue.

Regarding the Board's stock repurchase debate, Morrice said in his interview during the Examiner's investigation that there was a concern that the Directors who were pushing for stock repurchases did not understand the liquidity concerns that would accompany that strategy, and that he had to convince those directors that the liquidity concerns were real. Other Board members apparently did not need convincing that liquidity was the major issue facing New Century. For example, in connection with a January 2006 Board meeting, independent Director Fred Forster provided the Board of Directors with an "Issues Perspective" document in which the first topic was "Minimum Liquidity. In that document Forster expressed a concern that New Century's minimum liquidity position may not have been sufficient based on his experience in the mortgage banking business and in light of the uncertainties in that business.

Other members of the New Century Board advocated a different and more aggressive approach. They thought the Company should sell loans and use excess cash to repurchase stock, as opposed to what they viewed the Company as having done after the REIT conversion, which was to sell stock and buy loans. Some members of New Century's Senior Management disagreed with Board members regarding a stock repurchase strategy. They said they believed the Board focused too heavily on stock repurchases to manipulate EPS and that those repurchases would not benefit the Company.

In the fourth quarter of 2005, New Century's Board of Directors approved a share repurchase program for up to five million shares of common stock over a 12-month period. Under this program, New Century reported that, during the nine months ended September 30,

2006, it repurchased an aggregate of over 1.5 million of its shares at an average price of $43.03 per share, for an aggregate of over $64.5 million expended for stock repurchases.[164]

Forster's concerns about the impact of the stock repurchase strategy on the Company's liquidity were expressed in an August 13, 2006 letter to independent Director David Einhorn. In that letter, Forster said, "[W]hatever we do, we need to be very comfortable that less capital/liquidity does not in any material way threaten the very existence or viability of New Century." The Company provided the following summary of its liquidity strategy in its Form 10-Q for the third quarter of 2006: "We establish target levels of liquidity and capital based on a number of factors including our loan production volume, the general economic environment, the condition of the secondary market for our loans, the size and composition of our balance sheet and our utilization of various interest rate hedging techniques."[165] New Century reported the following liquidity positions, including cash and available borrowing capacity, for the following periods (dollars in millions):[166]

Period End	Reported Liquidity
12/31/2004	$987.4
12/31/2005	$530.4
9/30/2006	$457.1

Differences of opinion between New Century's Board and Senior Management also apparently existed regarding the Company's dividend policy. Some in Management reportedly wanted to distribute a strong dividend every quarter, while some Board members were not as interested in doing that. Some members of the Board apparently disagreed with an assertion by Management that the dividend was the best measure of New Century's performance. New Century's quarterly common stock dividend amounts and dates paid from 2005 through early 2007 are as follows:[167]

[164] Form 10-Q for Q3 2006 at 74.

[165] Form 10-Q for Q3 2006 at 75.

[166] Form 10-K for 2005 at 83; Form 10-Q for Q3 2006 at 76.

[167] Form 10-K for 2004 at 64; Form 10-K for 2005 at 84; Form 10-Q for Q2 2006 at 73; Form 10-Q for Q3 2006 at 83.

Dividend Payment Date	Dividend Amount (per share)
1/31/2005	$1.50
4/29/2005	$1.55
7/29/2005	$1.60
10/31/2005	$1.65
1/30/2006	$1.70
4/28/2006	$1.75
7/31/2006	$1.80
10/31/2006	$1.85
1/31/2007	$1.90

4. The Company's Information Systems and Automated Processes

A detailed review and analysis of New Century's information technology and data processing systems was beyond the scope of the Examiner's investigation. However, during the investigation, several interviewees provided information regarding the Company's information systems and this section provides a brief summary of those views.

Several interviewees told the Examiner that they thought 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's. In particular, New Century's loan production processes were apparently manual and people-intensive through the fall of 2005. Up to that time, New Century apparently used an outdated DOS-based loan underwriting and appraisal operating system, which, according to one Management interviewee, allowed users to "finagle anything."[168]

New Century's lack of automated processes for the receipt and tracking of loan repurchase claims before November 2006 was also cited as a weakness of the Company's information management system. According to several interviewees, before November 2006, there was no specific automated system or protocol for the receipt tracking or resolution of repurchase claims.

[168] DOS, or MS-DOS, was a disk operating system developed by Microsoft and widely used from the early 1980s through the mid-1990s, when it became the platform for Microsoft's Windows 95 and Windows 98 systems.

On the other hand, New Century used a web-based loan underwriting tool, known as FastQual, that apparently facilitated the online submission by third-party brokers of loan applications to the Company. FastQual apparently contributed to the efficiency and "ease of use" of the broker loan submission process at New Century.

5. Mortgage Loan Originations and Purchases

a. Overview

New Century originated and purchased mortgage loans through a wholesale division and a retail division.

i. Wholesale Mortgage Loan Division

New Century's wholesale mortgage loan division operated under the name New Century Mortgage Corporation ("NCMC").[169] NCMC was responsible for the majority of the Company's mortgage loan production volume.[170] For example, through the first nine months of 2006, the wholesale division was responsible for approximately 85% of the Company's total mortgage loan originations, with $38.6 billion in loans originated and purchased by the wholesale division, compared to $6.8 billion for the retail division.[171] A year earlier, in 2005, 87.7% (or $49.2 billion) of New Century's total mortgage loans were originated by the wholesale division.[172] As of September 30, 2006, the wholesale division operated through 33 regional operating centers in 19 states.[173]

New Century's wholesale division originated and purchased loans through a network of independent mortgage brokers and correspondent lenders identified and solicited by the Company's account executives.[174] These brokers and lenders entered into agreements with the Company in which they agreed to abide by Company policies and applicable laws.[175] The independent brokers would identify potential borrowers, assist them in completing loan applications, gather necessary documentation and serve as the liaison between the Company and

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[169] Form 10-K for 2005 at 4-5.

[170] Form 10-K for 2005 at 5.

[171] McCarthy Declaration at 3, para. 5; Form 10-Q for Q3 2006 at 42.

[172] Form 10-K for 2005 at 5.

[173] Form 10-Q for Q3 2006 at 42.

[174] Form 10-K for 2005 at 5; McCarthy Declaration at 2, para. 5.

[175] Form 10-K for 2004 at 8.

the borrower until the Company closed and funded their mortgage loans.[176] Correspondent lenders were independent mortgage bankers or financial institutions that sold the Company mortgage loans that had already been originated, closed and funded based on specifications provided by New Century.[177]

ii. Retail Mortgage Loan Division

Since May 2004, the Company's retail mortgage loan division operated under the name Home123 Corporation ("Home123").[178] Mortgage loans made through Home123, or the retail division, involved direct contact between borrowers and employees of the Company or its subsidiaries.[179] Borrowers came to New Century's retail division through a variety of channels, including the Company's 235 sales offices in 36 states (as of September 30, 2006) and the Company's telemarketing unit and website, and via referrals from builders, realtors or other third-parties.[180] As indicated above, the retail division originated $6.8 billion in mortgage loans during the first nine months of 2006, representing approximately 15% of the loans originated by New Century during that period.[181] In 2005 the retail division originated $6.9 billion in mortgage loans, representing 12.3% of the loans originated by New Century that year.[182]

b. Mortgage Loan Product Mix and Changes in the Mix

The following table shows the types of mortgage loan products that were originated and purchased by New Century from 2004 through the third quarter of 2006 (dollars in thousands):

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[176] *Id.*; McCarthy Declaration at 2-3, para. 5.

[177] McCarthy Declaration at 3, para. 5.

[178] Form 10-K for 2005 at 6.

[179] McCarthy Declaration at 3, para. 6.

[180] *Id.*; Form 10-K for 2005 at 4.

[181] Form 10-Q for Q3 2006 at 42.

[182] Form 10-K for 2005 at 5.

	Year Ended Dec. 31, 2004		Year Ended Dec. 31, 2005		9 Months Ended Sept. 30, 2006	
Fixed Rate	**Total**	**%**	**Total**	**%**	**Total**	**%**
15-30 Year	$11,086,399	26.3	$13,845,595	24.6	$10,453,768	23.0
Interest-Only	---	---	$671,824	1.2	$1,096,951	2.4
40-Year	---	---	$489,697	0.9	$2,403,604	5.3
HELOC[183]	---	---	---	---	$239	--
Fixed Subtotal	$11,086,399	26.3	$15,007,116	26.7	13,954,562	30.7
Adjustable Rate						
15-30 Year	$22,969,212	54.4	$21,194,109	37.8	$9,161,140	20.2
Interest-Only	$8,144,029	19.3	$16,580,514	29.6	$6,621,009	14.6
40-Year	---	---	$3,298,913	5.9	$15,653,449	34.4
HELOC	---	---	$27,589	--	$53,112	0.1
ARM Subtotal	$31,113,241	73.7	$41,101,125	73.3	$31,488,710	69.3
Total Originations and Purchases	$42,199,640	100.0	$56,108,241	100.0	$45,443,272	100.0
Purchase Money Mortgages[184]	$14,880,034	35.3	$23,571,645	42.0	$20,338,741	44.1
Refinances[185]						
Cash-out	$25,121,511	59.5	$27,130,520	48.4	$20,338,741	44.8
Rate/Term	$2,198,095	5.2	$5,406,076	9.6	$5,065,173	11.1
Total PMM[186] & Refi	$42,199,640	100.0	$56,108,241	100.0	$45,443,272	100.0
Documentation						
Full	$21,530,191	51.0	$30,438,822	54.2	$25,303,436	55.7
Limited	$2,014,253	4.8	$1,501,367	2.7	$922,042	2.0
Stated	$18,655,196	44.2	$24,168,052	43.1	$19,217,794	42.3
Total	$42,199,640	100.0	$56,108,241	100.0	$45,443,272	100.0
Weighted Average FICO Score of Loans	627		634		634	
Weighted Average LTV Ratio of Loans	81.1%		81.0%		81.1%	

As this information shows, non-traditional mortgage loan products, such as interest-only loans and 40-year-amortizing loans, became a larger part of New Century's loan mix from 2004 through the third quarter of 2006. Interest-only ARM loans increased from just over 19% (or $8.1 billion) of all loans originated and purchased in 2004 to nearly 30% (or $16.6 billion) in 2005. In addition, 40-year-amortizing ARM loans grew from only about six percent (or $3.3

[183] "HELOC" means Home Equity Line of Credit.

[184] Purchase money mortgages are mortgage loans taken by borrowers to acquire a residence.

[185] Cash-out refinancings involve borrowers "taking money out" of the equity in their homes through the refinancing. Rate and term refinancings are transactions in which borrowers refinance to obtain a better interest rate, lower payment and/or different loan maturity.

[186] "PMM" means Property Market Metric.

billion) of all loans in 2005 to over 34% (or $15.7 billion) by the end of the third quarter of 2006. Also noteworthy from this data are the relatively high proportion of "stated income" mortgage loans that were being originated and purchased by New Century (in the low-to-mid 40% range, or between $18.7 and $24.2 billion dollars in loans per period) and the relatively high (though decreasing) proportion of cash-out refinancings over this time period (from 59.5% in 2004 to 44.8% in 2006, or between $27.1 billion and $20.3 billion in loans originated).

"Stated income" loans involve no documentation regarding a borrower's income; instead, the loan is made based on the borrower's statement as to the amount of his or her income. Secondary sources are often used to verify the borrower's ability to repay the loan. Stated income loans are often referred to in the industry as "liars' loans" because of the tendency of some borrowers to overstate their incomes.[187]

With respect to its level of cash-out refinancings, New Century stated in its Form 10-Q for the third quarter of 2006: "Over the last 12 months, we have made a concerted effort to increase our home purchase business. These efforts, coupled with market and economic conditions and the addition of the RBC Mortgage loan origination platform, have enabled us to decrease the percentage of cash-out refinancings as compared to home purchase finance loans."[188] New Century had acquired certain of the loan origination assets of RBC Mortgage Company in September 2005. The Company said the acquisition "expanded our offerings to include conventional mortgage loans, including Alt-A mortgage loans, loans insured by the . . . FHA, and loans guaranteed by the . . . VA."[189]

c. Mortgage Loan Origination Process

New Century's wholesale mortgage loan origination process, and its interaction with independent loan brokers, worked as follows, as described by the Company:[190]

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[187] Dan Dorfman, *Liars' Loans Could Make Many Moan*, N.Y. Sun, Dec. 20, 2006, *available at* http://www.nysun.com/article/45441. This article reports that "a recent sampling of 100 stated-income loans by an auditing firm in Virginia (based on IRS records) found that 90% of the income statements were exaggerated by 5% or more, while almost 60% of the stated amounts were exaggerated by more than 50%." E. Scott Reckard, *Defaults exposing truth of "liar's loans"*, Los Angeles Times, Jan. 15, 2008, *available at* http://seattletimes.nwsource.com/html/businesstechnology/2004125368_liarloans15.html. This article includes the following quote: " 'This is not a subprime crisis. This is a stated-income crisis,' said Robert Simpson, chief executive of Investors Mortgage Asset Recovery in Irvine, Calif., which works with lenders, insurers and investors to recover losses related to mortgage fraud."

[188] Form 10-Q for Q3 2006 at 43.

[189] Form 10-Q for Q3 2006 at 38.

[190] Form 10-K for 2005 at 5.

> In wholesale loan originations, the broker's role is to identify the applicant, assist in completing the loan application form, gather necessary information and documents and serve as our liaison with the borrower through our lending process. We review and underwrite the application submitted by the broker, approve or deny the application, set the interest rate and other terms of the loan and, upon acceptance by the borrower and satisfaction of all conditions imposed by us, fund the loan. . . . Mortgage brokers can submit loan applications through an account executive or through FastQual, our Web-based loan underwriting engine, at *www.newcentury.com.* In either case, the mortgage broker will forward the original loan package to the closest regional operating center where the loan is logged in for regulatory compliance purposes and approved or denied within 24 hours of receipt in most cases. If approved, we issue a "conditional approval" to the broker with a list of specific conditions that have to be met (for example, credit verifications and independent third-party appraisals) and additional documents to be supplied prior to the funding of the loan. An account manager and account executive work directly with the submitting mortgage broker who originated the loan to collect the requested information and to meet the underwriting conditions and other requirements. In most cases, we fund loans within 30 days from the date of our approval of an application.

In other words, for wholesale loan originations, independent brokers found potential borrowers and filled out the loan applications, which were submitted to New Century account executives. Employees interviewed during the investigation said that account executives did not have lending authority and did not have access to New Century's loan origination or underwriting systems. Account executives submitted loan applications to account managers, who reviewed the applications to ensure that the proper documentation had been gathered by the brokers. Account managers did not have lending authority. After all the proper documentation was in place and on New Century's systems, the account manager forwarded the loan applications to the Company's underwriters.

Underwriters at New Century performed traditional underwriting tasks and determined whether to approve a loan. In other words, they had lending authority. Brokers could not communicate with New Century's underwriters. After an underwriter approved a loan, the loan was sent to a closing agent (an escrow or title agent) for closing and execution of the loan documents. After the loan documents were executed, they were forwarded to a New Century funding officer. The funding officers ensured that all of the documents were properly executed. If everything was in order, the funding officer would contact the Accounting Department and request that a wire be sent to the closing agent.

All New Century employees involved in this loan origination process reported to a regional manager. The regional managers reported to divisional managers. The regional and divisional managers had lending authority and could override the decisions of the underwriters who reported to them.

Loan originations in the retail division operated the same as the wholesale division, with a couple of notable exceptions. First, the underwriters in the retail division did not report to Production Department Management. Second, the regional managers in the retail division did not have lending authority and, thus, could not override the decisions of the underwriters.

d. Underwriting Standards and Processes

As indicated above, the loan origination and underwriting process at New Century involved reviewing loan documentation and borrower information to determine compliance with the Company's underwriting standards. In its Form 10-K for 2005, New Century said the following about its underwriting standards:[191]

> Our loan origination standards and procedures are designed to produce high quality loans. These standards and procedures encompass underwriter qualifications and authority levels, appraisal review requirements, fraud prevention, funds disbursement controls, training of our employees and ongoing review of our employees' work. We help to ensure that our origination standards are met by employing accomplished and seasoned managers, underwriters and processors and through the extensive use of technology. We also have a comprehensive training program for the continuing development of both our existing staff and new hires. In addition, we employ proprietary underwriting systems in our loan origination process that improve the consistency of underwriting standards, assess collateral adequacy and help to prevent fraud, while at the same time increasing productivity. . . . We periodically evaluate and modify our underwriting guidelines. We also adopt new underwriting guidelines appropriate to new loan products we may offer.

e. Appraisal Reviews

Appraisals were a key part of the underwriting process at New Century. The Company had two types of appraisers: a corporate appraisal group and a staff of review appraisers. The corporate appraisal group maintained a list of outside appraisers that had been approved (or disapproved) to provide appraisals in connection with loan applications that were submitted to New Century. The corporate appraisal group also participated in the hiring of the review appraisers. The review appraisers were responsible for reviewing and determining the

[191] *Id.* at 8.

acceptability of the outside appraisals that were attached to loan applications provided by brokers. When a broker submitted a loan application to New Century, the review appraisers would first check to see if the outside appraiser was on the approved or disapproved list. If the outside appraiser was not on the approved or disapproved list, the review appraiser would submit the outside appraiser for approval by the corporate appraisal group. If the outside appraiser was approved, the review appraiser would then determine the acceptability of the appraisal.

In its Form 10-K for 2005, New Century described its appraisal review process as follows:[192]

> A qualified independent appraiser inspects and appraises each mortgage property and gives an opinion of value and condition. Following each appraisal, the appraiser prepares a Report that includes a market value analysis based on recent sales of comparable homes in the area and, when appropriate, replacement cost analysis based on the current cost of constructing a similar home. All appraisals must conform to the Uniform Standards of Professional Appraisal Practice adopted by the Appraisal Foundation's Appraisal Standards Board and are generally on forms acceptable to Fannie Mae and Freddie Mac. Our underwriting guidelines require a review of the appraisal by one of our qualified employees or by a qualified review appraiser that we have retained. Our underwriting guidelines then require our underwriters to be satisfied that the value of the property being financed, as indicated by the appraisal, would support the requested loan amount.

Employees interviewed during the investigation added the following information about New Century's appraisal review process: New Century's automated systems were programmed with certain business rules related to the appropriateness of appraisals. When an appraisal fell outside of those rules, it would be flagged by the system. The responsible underwriter would send the flagged appraisal to an internal New Century appraiser. The internal appraisers would review the appraisal and decide whether to accept or reject it. Because they were licensed appraisers, the New Century internal appraisers also could decrease appraisals. However, they could not increase appraisals. In the wholesale division, the regional managers who had lending authority could override the internal appraisers' decisions. When a regional manager overrode an appraiser's decision, New Century's automated systems reported this information and a report regarding appraisal overrides was sent to the Corporate Credit Officer.

In his interview during the Examiner's Investigation, Morrice said New Century undertook several initiatives to improve the reliability of appraisals, but he also indicated that

[192] Form 10-K for 2005 at 8.

bad appraisals were a frustrating source of concern and the main cause of loan "kickouts," which was the rejection of loans by investors in whole loan sale transactions. Morrice also said that improper appraisals were the biggest contributors to losses when loans went bad. However, Morrice also stated that, in his view, New Century was "in the mainstream on appraisal practices."

6. Financing New Century's Operations: Warehouse Loans and Liquidity

To finance and carry the mortgage loans New Century originated and purchased, pending their sale or securitization in the secondary mortgage market, the Company maintained credit facilities, typically in the form of master repurchase agreements, with multiple warehouse lenders, which were large banking and investment institutions.[193] Typically, the master repurchase agreements between New Century and the warehouse lenders contained covenants that required the Company, among other things, to maintain certain liquidity levels and net worth and debt-to-equity ratios, and to limit the Company's indebtedness.[194] New Century's breach of any covenant typically triggered a warehouse lender's right to terminate its master repurchase agreement with the Company and to accelerate the Company's repayment obligation,[195] which is often referred to as the obligation to repurchase mortgage loans financed under the master repurchase agreement.[196] Moreover, New Century's default under any one master repurchase agreement with a warehouse lender generally triggered the right of the Company's other warehouse lenders to accelerate repayment or repurchase under their master repurchase agreements with the Company.[197]

At the end of the third quarter of 2006, the Company reported that it had outstanding approximately $8.5 billion in short-term borrowings under 14 separate master repurchase agreements and an asset-backed commercial paper facility, all of which were secured by mortgage loans held for sale and other assets of the Company.[198] For year-end 2005, the

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[193] Form 10-Q for Q3 2006 at 10, 77-79; McCarthy Declaration at 3, para. 8.

[194] Form 10-Q for Q3 2006 at 69.

[195] *Id.* at 70.

[196] McCarthy Declaration at 7, para. 19.

[197] Form 10-Q for Q3 2006 at 70.

[198] *Id.* at 17. The $8.5 billion outstanding under master repurchase agreements and the commercial paper facility is in addition to the approximately $13.9 billion in securitized bonds the Company reported as its financing on mortgage loans held for investment at September 30, 2006. *Id.* at 19.

Company reported that it had outstanding approximately $7.4 billion in short-term borrowings under 10 separate master repurchase agreements and an asset-backed note purchase and security agreement.[199]

Some warehouse lenders funded loans placed on their warehouse lines before the receipt by the lender's custodian of the loan documentation packages for the loans being funded. This is referred to in the industry as "wet funding." Other lenders would not fund until the custodian's receipt of the loan packages, which is referred to as "dry funding." If the loan packages for "wet funded" loans were not received by the custodian within seven days of the funding, New Century had an obligation to buy those loans back from the warehouse lender.

Under the master repurchase agreements between New Century and its warehouse lenders, each lender also had the right to initiate a margin call, which required the Company to provide the lender with additional collateral or repay a specified portion of the outstanding borrowing, if the lender determined that the value of the mortgage loan collateral that secured the borrowing had decreased below a set amount.[200] The exercise of these margin call rights by New Century's warehouse lenders in March 2007 had a significantly negative impact on the Company's liquidity position and was a main factor that contributed to the Company's decision to file in bankruptcy.[201]

7. Secondary Mortgage Market Activities

a. Overview

New Century's secondary mortgage market activities consisted principally of whole loan sales, securitizations structured as sales, and securitizations structured as financings.

New Century sold whole loans pursuant to non-recourse purchase agreements that included representations and warranties regarding loan characteristics and the loan origination process. These generally included New Century's commitment to repurchase or substitute a loan in the event of an EPD—i.e., a default within the first month or two following the sale of the loan—or in the event of a material breach of the representations or warranties made by New Century regarding loan characteristics and the loan origination process.[202] The proceeds of

[199] Form 10-K for 2005 at F-31. This amount is in addition to the approximately $16 billion in securitized bonds the Company reported as its financing on mortgage loans held for investment at December 31, 2005. *Id.* at F-33.

[200] Form 10-K for 2005 at 37; McCarthy Declaration at 7, para. 18.

[201] McCarthy Declaration at 14, para. 50.

[202] Form 10-K for 2005 at 10.

whole loan sales were used to pay down warehouse lines and the Company's asset-backed commercial paper note facility.[203]

In a securitization structured as a sale, New Century sold a pool of loans to a trust in exchange for cash and a certificate evidencing an economic interest in the trust—known as a "residual interest."[204] The trust raised the cash portion of the purchase price by selling certificates representing senior interests in the underlying loans in the trust.[205] These transactions were accounted for as sales under applicable accounting standards, and New Century recognized gain on the sale.[206] New Century also received certain cash flows from its residual interests.[207] In 2005, these cash flows totaled $17.5 million (including approximately $17 million categorized as interest income).[208] As of September 30, 2006, these cash flows were reported to be approximately $2.1 million.[209]

As indicated above, in 2003 New Century began a strategy of keeping loans on its balance sheet through securitizations structured as financings rather than as sales.[210] During the period from 2003 to 2005, New Century retained approximately 20 to 25% of total loan production on its balance sheet in this manner.[211] When loans were held on New Century's balance sheet, the Company recognized interest payments on the underlying mortgage loans in the portfolio as payments were received, rather than recognizing gain on the sale of loans.[212] The proceeds of New Century's securitizations, whether structured as sales or financings, were also used to pay down the warehouse lines and asset-backed commercial paper note facility.[213]

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[203] *Id.*

[204] *Id.* at 11.

[205] *Id.*

[206] *Id.*

[207] *Id.*

[208] Form 10-K for 2005 at F-14, F-35.

[209] Form 10-Q for Q3 2006 at 5.

[210] Form 10-K for 2005 at 56.

[211] *Id.*

[212] *Id.* at 62.

[213] *Id.* at 10.

New Century's whole loan sales and loan securitizations were conducted by its Secondary Marketing Department, New Century Capital Corporation. [214] In 2005, whole loan sales comprised approximately 67% of New Century's secondary mortgage market transactions, while securitizations structured as sales and securitizations structured as financings comprised, respectively, approximately 12.2% and 20.8% of the total.[215] In dollar terms, of $52.7 billion in total secondary market transactions reported in 2005, approximately $35.3 billion were whole loan sales, $6.4 billion were securitizations structured as sales, and $11.0 billion were securitizations structured as financings.[216] For the nine months ended September 30, 2006, New Century reported that whole loan sales accounted for approximately 93.4% of the Company's secondary market activities, with approximately $41.1 billion in loans being sold.[217] For that nine-month period, New Century reported no securitizations structured as sales and approximately $3.4 billion, or 7.7% of all secondary market transactions during that period, in securitizations structured as financings.[218]

Generally, New Century sold or securitized loans it originated or purchased within 30 to 90 days after the loans were originated or purchased by the Company.[219] The analysis and decision-making process regarding whether New Century would sell or securitize loans generally was as follows: the Secondary Marketing Department would calculate the appropriate prices, discuss liquidity issues with the treasury group, and make a proposal to the CEO, who ultimately made the decision whether to sell or securitize. The New Century Board would ratify the decision. The decision was essentially a balancing question, *i.e.*, the sales price for the loans if sold by Secondary Marketing versus liquidity concerns if the loan were placed in the portfolio. New Century's Board of Directors typically received information regarding the Company's secondary marketing strategy, including information about whole loan sales and loan securitizations.

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[214] Form 10-K for 2004 at 15, 37.

[215] Form 10-K for 2005 at 61.

[216] *Id.*

[217] Form 10-Q for Q3 2006 at 46-47.

[218] *Id.*

[219] Form 10-K for 2005 at 10.

b. Whole Loan Sale Process: "Kickouts" and "Scratch and Dents"

Each month, New Century typically had a few billion dollars in whole mortgage loans to sell in the secondary market. When New Century put together a pool of loans to sell, it would either send a bid list that included data about the loans in the pool to a group of potential investors or send the data to a targeted investor that New Century believed would be interested in the loans being sold. When deciding whether to offer to sell whole loans to an investment bank, the Company considered whether the bank was providing New Century with a warehouse line of credit. The potential investors would review the information and contact New Century regarding loans the investors wanted "kicked out" of the pool because of missing data or data outside the range of what was expected for the loan pool. Over time, and based on its experience with potential investors, New Century developed a database with a set of queries that looked for "bad" loan data before the data was sent to investors. If a value about the characteristics of a specific loan in the data warehouse was missing or outside a standard range, the loan was "kicked out" by the database for examination and to address the problematic values. This amounted to an after-the-fact quality control on the loans that had been recorded in New Century's data warehouse. Before this process was developed in 2006, this control was performed manually on each data tape that went out to potential investors.

Once an agreement on a whole loan sale transaction was reached with an investor, New Century, through its Secondary Marketing Department, would coordinate due diligence with the investor. At the investor's request, the Secondary Marketing Department would forward a representative sample of the loan files from the loans in the pool to the investor. The size of the representative sample varied, but it was usually around 25% of the total loans in the pool. By late-2006, some investors were requiring higher sample rates, including some that required a 100% due diligence review of a pool's loan files. The investor, or a due diligence firm hired by the investor, would review the files to determine that the loans were underwritten according to the pool's guidelines. The investor would also look at the appraisals to uncover any potential valuation issues. The investor would then send a list of problem loans to a loan sale coordinator at New Century, who would review the problems identified and attempt to resolve them. In the case of loans that met New Century's general underwriting guidelines but did not meet the investor's guidelines, the loan sale coordinator would attempt to persuade the investor that the loan was nonetheless acceptable. For any loan that was non-performing (i.e., the borrower was

not making payments) or that was discovered not to have met New Century's own underwriting guidelines, no attempt was made to avoid "kicking" the loan out of the pool.

After New Century and the investor agreed upon the "kickouts" from a loan pool, the parties would complete the whole loan sale transaction. This was accomplished by (1) a transfer of the loans being sold from the warehouse lenders to New Century, via the warehouse lenders' custodian, and from New Century to the investor, and (2) payment by the investor to the warehouse lenders on whose warehouse lines the loans had been.

Meanwhile, the loan sale coordinator at New Century would categorize the deficiency of the loan "kickouts" as either egregious or non-egregious. An example of a non-egregious deficiency would be that a particular investor is sensitive to stated income or high debt-to-income ratios, whereas another investor might accept such loans. An example of an egregious deficiency would be non-performing loans and loans that did not comply with New Century's underwriting standards. For non-egregious kickouts, the loan would be moved to another loan pool for potential sale to other investors. For egregious kickouts, the loan would be moved to the so-called "scratch and dent" category in the Company's loan inventory.

New Century sold scratch and dent loan pools from time to time in discounted loan sales. As described by the Company, discounted loans "consisted of repurchased loans, loans with documentation defects or loans that whole loan buyers rejected because of certain characteristics."[220] The Company would assemble a pool of scratch and dent loans and then send out bid documents to investors, which were typically specialized scratch and dent firms or separate scratch and dent "desks" at investment banks. The bid documents described what was wrong with the loans by listing, in a data file, the various deficiencies. The investor due diligence process for scratch and dent loan pools was similar to the due diligence process for the regular loan pools. However, the amount of kickouts was lower because the investors generally knew the problems with the scratch and dent loans. If problems were identified in a scratch and dent loan pool, instead of kickouts, the loans would generally stay in the pool and the value of the pool would drop in proportion to the "loss" related to the problems.

In 2004, New Century sold $148.1 million in loans at a discount to their outstanding principal balance, representing 0.4% of the Company's total secondary market transactions that

[220] Form 10-K for 2005 at 63.

year.[221] In 2005, New Century sold $246.5 million in loans at a discount to their outstanding principal balance, representing 0.5% of the Company's total secondary market transactions for that year.[222] For the nine-month period ended September 30, 2006, the Company sold $916.3 million of loans in discounted loan sales, representing 2.1% of the Company's total secondary market transactions for that time period.[223]

c. Securitization Structures and Processes

As indicated above, New Century engaged in two types of securitizations in which loans were pooled and securities based on the loan pools were sold to investors: (1) securitizations structured as sales, known as off-balance sheet securitizations, and (2) securitizations structured as financings.

In its Form 10-Q for the third quarter of 2006, the Company described its securitizations structured as sales:[224]

> We generally structure off-balance sheet securitizations as follows: first, we sell a portfolio of mortgage loans to a special purpose entity ("SPE") that has been established for the limited purpose of buying and reselling mortgage loans; then the SPE transfers the same mortgage loans to a real estate mortgage investment conduit . . . or owners trust (the "Trust"), which is a qualifying special purpose entity . . . as defined under Statement of Financial Accounting Standards No. 140 . . .; and, finally, the Trust issues (i) interest-bearing asset-backed securities (the "Bonds and Certificates") generally in an amount equal to the aggregate principal balance of the mortgage loans and (ii) a certificate to us representing a residual interest in Cash Flows related to the payments made on the securitized loans. The Bonds and Certificates are typically sold at face value on a non-recourse basis, except that we provide to the Trust representations and warranties customary in the mortgage banking industry. One or more investors typically purchase these Bonds and Certificates for cash. The Trust uses the cash proceeds to pay us the cash portion of the purchase price for the mortgage loans. In addition, we may provide a credit enhancement in the form of additional collateral (the "OC") held by the Trust. The servicing agreements typically require that the OC be maintained at certain levels.

New Century's securitizations structured as financings were structured similarly to the Company's securitizations structured as sales, with the following important differences: (1) the securitization trusts did not meet the qualifying special purpose entity criteria under Statement of

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[221] Form 10-K for 2005 at 61.

[222] *Id.*

[223] Form 10-Q for Q3 2006 at 46.

[224] Form 10-Q for Q3 2006 at 50.

Financial Accounting Standards ("FAS") 140 and related interpretations because of their ability to enter into derivative contracts, and (2) the Company had the option to purchase loans from the securitization trust at the Company's discretion.[225] In addition, the Company's accounting treatment of the two types of securitizations was quite different, with the loans in a securitization structured as a financing remaining on the Company's balance sheet as "mortgage loans held for investment."[226]

In a securitization structured as a sale, the securitized loans went off of the Company's balance sheet and the Company recorded on its balance sheet (i) the cash received in the transaction, (ii) the fair value of the residual interests in the securitized loans, and (iii) the estimated fair value of the servicing rights, if the loans were securitized with servicing retained by New Century.[227] The excess of the cash received and the servicing asset retained, if any, over the carrying value of the loans sold, less transaction costs, equaled the net gain on sale of mortgage loans recorded by New Century in its statement of earnings.[228]

8. Mortgage Loan Servicing

As indicated above, New Century engaged in mortgage loan servicing through one of its taxable REIT subsidiaries.[229] The Company described its loan servicing activities as follows:[230]

> Loan servicing activities are designed and implemented to ensure that each loan in a mortgage servicing portfolio is repaid in accordance with its terms. Such activities are generally performed pursuant to servicing contracts we enter into with investors or their agents in connection with whole loan sales or securitizations. The servicing functions performed typically include: collecting and remitting loan payments; making required advances; accounting for principal and interest; customer service; holding escrow or impound funds for payment of taxes and insurance; and, if applicable, contacting delinquent borrowers and supervising foreclosures and property dispositions in the event of un-remedied defaults. For performing these functions for third parties we generally receive a servicing fee of 0.50% annually of the outstanding principal balance of each loan in the mortgage servicing portfolio. The servicing fees are collected from the monthly payments made by the mortgagors. In addition, we generally receive other remuneration consisting of float benefits derived from collecting and

[225] Form 10-K for 2005 at 63.

[226] *Id.*

[227] Form 10-Q for Q3 2006 at 50.

[228] *Id.*

[229] Form 10-K for 2005 at 12.

[230] *Id.*

remitting mortgage payments, as well as mortgagor-contracted fees such as late fees and, in some cases, prepayment penalties.

As of September 30, 2006, the balance of New Century's mortgage loan servicing portfolio was $43.3 billion, which included $12.9 billion of mortgage loans held for investment, $8.5 billion of mortgage loans held for sale, $9.2 billion of mortgage loans sold on a servicing-retained basis, and $12.7 billion of loans serviced on a temporary basis for purchasers of the loans pending transfer of servicing rights to the purchaser or its designee.[231] New Century reported servicing income of $28.9 million in 2004, $38.5 million in 2005, and $47.4 million for the nine months ended September 30, 2006.[232]

As discussed above, most of New Century's whole loan sales and securitizations structured as sales were done on a servicing-released basis, meaning New Century did not retain the servicing rights to the loans it sold or securitized. According to Richard Cimino, who was the head of Loan Servicing at New Century, the Company made efforts to increase its servicer rating from third-party rating agencies so that it would be in a position to retain more servicing rights with respect to loans sold and securitized. New Century described its desire to retain servicing rights, and the improvement in the rating of its servicing platform, as follows:[233]

> We intend to continue to retain servicing rights on certain of the loans we sell in future periods. In the second quarter of 2004, we received a rating of RPS3+, or average with noted strengths, from Fitch Ratings for our subprime servicing platform. In 2005, we received a rating of SQ3+, or average, from Moody's Credit Rating Service and, in January 2006, Standard and Poor's upgraded its rating for our subprime servicing platform to above average from average.

9. Mortgage Loan Repurchases

As described above, New Century had an obligation under whole loan sale agreements, and in connection with securitization transactions, to repurchase loans under certain circumstances. New Century described its repurchase obligations as follows in its Form 10-K for 2005:[234]

> When we sell mortgage loans, we are required to make customary representations and warranties about such mortgage loans to the purchaser. Our whole loan sale agreements require us to repurchase or substitute mortgage loans in the event we

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[231] *Id.*

[232] Form 10-K for 2005 at 67; Form 10-Q for Q3 2006 at 61.

[233] Form 10-K for 2005 at 13.

[234] *Id.* at 40.

> breach a representation or warranty given to the mortgage loan purchaser or make a misrepresentation during the mortgage loan origination process. In addition, we may be required to repurchase mortgage loans as a result of borrower fraud or in the event of early payment default on a mortgage loan. Likewise, we are required to repurchase or substitute mortgage loans if we breach a representation or warranty in connection with our securitizations.

Once a loan was repurchased by New Century, the value of the loan was substantially impaired. As the Company stated in its Form 10-K for 2005: "[R]epurchased mortgage loans typically can only be financed at a steep discount to their repurchase price, if at all. They are also typically sold at a significant discount to the unpaid principal balance."[235]

Notices of loan repurchase claims were received by New Century's Secondary Marketing Department, usually by the person with whom the investor making the repurchase claim last dealt with at New Century. When a repurchase claim was based upon a breach of representations and warranties made in a whole loan sale or a securitization transaction, resolution of the issue was assigned to the department within New Century that needed to investigate the issue. For example, fraud and legal issues were sent to the Company's Legal Department and underwriting issues were sent to the Loan Production Department. The department investigating the issue had to approve the repurchase claim request prior to payment being made on the claim. If approved for payment, the Secondary Marketing Department contacted the claimant and facilitated payment for the repurchase of the loan through the Accounting Department. If a repurchase claim was denied, however, the denying department within New Century was responsible for communicating directly with the repurchase claimant. This decentralization reportedly delayed the processing and resolution of repurchase claims, which contributed to a back-log of repurchase claims.

By no later than the end of 2005, a build-up or back-log of unresolved repurchase claims had begun to develop at New Century, and the volume of repurchase claims being received by New Century increased significantly in 2006. By mid-2006, New Century had approximately $224 million of unresolved repurchase claims, of which approximately $170 million were more than two months old and approximately $75 million of those were more than six months old. The build-up of this back-log and concerns about the lack of good tracking and resolution

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[235] *Id.*

processes for repurchase claims led to the creation of a "repurchase desk" within the Secondary Marketing Department in the fall of 2006.

A significant change in the funding of repurchases occurred in January 2007. Before that time, New Century would sometimes repurchase loans with cash before arranging warehouse line financing. As a result, however, there was sometimes a delay between when cash went out to repurchase and when cash came back in. That procedure changed early in 2007 when cash became scarce and the Company's repurchase volume increased. After January 2007, New Century could only make repurchases when it had the funding to do so.

D. Risks to New Century's Business

New Century faced a number of risks in its business, including in the following general areas:

- Credit risk involving mortgage loan borrowers. This risk was particularly acute for New Century (and other subprime lenders) because of the relatively higher risk nature of subprime mortgage borrowers.
- Market risk involving changes in interest rates, housing values, warehouse lenders' willingness to finance New Century's mortgage lending operations, and secondary market investors' appetites for whole loan sales and securitizations offered by New Century.
- Operational risks involving the Company's ability to purchase or originate, and to sell or securitize, mortgage loans—and to account for those transactions and properly reserve against risks relating to those transactions—in an efficient and accurate manner that complied with the Company's internal policies and guidelines and with applicable accounting principles.

The following paragraph headings from New Century's risk disclosures in its Form 10-K for 2005 indicate the breadth and nature of the credit, market and operational risks New Century faced:[236]

- "We are dependent on external sources of financing, and if we are unable to maintain adequate financing sources, our earnings and our financial position will suffer and jeopardize our ability to continue operations."
- "A prolonged economic slowdown or a lengthy or severe recession could harm our operations, particularly if it results in a decline in the real estate market."
- "Our earnings may decrease because of increases or decreases in interest rates."

[236] *Id.* at 27-40.

- "Our reliance on cash-out refinancings as a significant source of our origination volume increases the risk that our earnings will be harmed if the demand for this type of refinancing declines."
- "Our accounting policies and methods are fundamental to how we report our financial condition and results of operations, and they may require Management to make estimates about matters that are inherently uncertain."
- "Our hedging strategies may not be successful in mitigating our risks associated with interest rates."
- "An increase in mortgage loan prepayments may negatively affect the yields on our assets."
- "The mortgage loans that we hold are subject to the risks of delinquency and foreclosure loss, which could result in losses to us."
- "The geographic concentration of our mortgage loan originations increases our exposure to economic and natural hazard risks specific to those areas."
- "An interruption or reduction in the securitization and whole loan markets would harm our financial position."
- "Our earnings from holding mortgage-backed securities or government securities may be harmed by changes in the level of interest rates, changes to the difference between short- and longer- term interest rates, changes to the difference between interest rates for these securities compared to other debt instruments, and an absence of or reduction in the availability, at favorable terms, of repurchase financing and other liquidity sources typically utilized by mortgage REITs."
- "A material difference between the assumptions used in the determination of the value of our residual interests and our actual experience could harm our financial position."
- "Our interest-only mortgage loans may have a higher risk of default than our fully-amortizing mortgage loans and, therefore, may be considered less valuable than other types of mortgage loans in the sales and securitization process."
- "We may incur losses on our mortgage loans even if the mortgage loans are insured by the Federal Housing Administration or guaranteed by the Veterans Administration."
- "Our inability to realize cash proceeds from mortgage loan sales and securitizations in excess of the loan acquisition cost could harm our financial position."
- "Our credit facilities are subject to margin calls based on the lender's opinion of the value of our mortgage loan collateral. An unanticipated large margin call could harm our liquidity."
- "Our origination and servicing systems depend significantly on automated controls and any failure of these systems could harm our business."

- "Our efforts to increase our servicing activities may be unsuccessful and a decline in the quality of servicing could lower the value of our residual interests and our ability to sell or securitize mortgage loans and could harm the cash flows from our securitizations structured as financings."
- "We are subject to losses due to fraudulent and negligent acts on the part of mortgage loan applicants, mortgage brokers, other vendors and our employees."
- "Changes in the volume and cost of mortgage loans originated by our Wholesale Division may decrease our mortgage loan production and decrease our earnings."
- "We may be required to repurchase mortgage loans or indemnify investors if we breach representations and warranties, which could harm our earnings."

E. Overview of New Century's Board, Management and Other Key Players

This subsection describes New Century's organizational structure and identifies and provides information about its Directors, key Management, and other personnel.

1. Board of Directors

New Century's Board of Directors in early-March 2007 consisted of the following individuals:[237]

Name	Independent Director (or Officer Position)	Director Since
Marilyn A. Alexander	Independent Director	2005
Harold A. Black	Independent Director	2004
Robert K. Cole	Chairman (through December 2006) and Chief Executive Officer (through June 2006)	1995
David Einhorn	Independent Director (since March 2006)	2006
Frederic J. Forster	Independent Director	1997
Edward F. Gotschall	Vice Chairman-Finance (through June 2006)	1995
Donald E. Lange	Independent Director	2002
Brad A. Morrice	Vice Chairman, President and Chief Operating Officer (through June 2006), Chief Executive Officer (from July 2006)	1995
William J. Popejoy	Independent Director	2002
Michael M. Sachs	Independent Director	1995
Richard A. Zona	Independent Director	2000

As this table shows, New Century's founders, Morrice, Gotschall and Cole, all served on the Company's Board of Directors. However, pursuant to the Company's Corporate Governance

[237] *See* Proxy Statement, filed Apr. 11, 2005; Proxy Statement, filed Apr., 2006.

Guidelines, independent Directors—that is, directors with no material relationship to the Company other than that of director—constituted the majority of the Board.[238]

New Century's Board included three certified public accountants (Alexander, Sachs and Zona), one member with a PhD (Black), four members with M.B.A. degrees (Alexander, Cole, Forster and Morrice), two members with law degrees (Morrice and Sachs), and several members with considerable years of experience in the banking, mortgage banking and financial services industries (notably Black, Cole, Forster, Gotschall, Lange, Morrice, Popejoy and Zona).[239]

2. Board Committees

The New Century Board of Directors had the following committees: Audit; Compensation; Executive; Finance; Governance and Nominating; Public and Community Affairs; and Stock Option.[240] Of these, the most significant for purposes of this Final Report are the Audit and Finance Committees.

The following Independent Directors were members of the Audit Committee from 2005 through the Company's bankruptcy filing: Sachs (Chairman), Alexander, Lange and Zona.[241] The Audit Committee generally met at least monthly, and, occasionally, more than once a month. Among the types of matters the Committee discussed and reports the Committee received in its meetings in 2005, 2006 and 2007 were the following: compliance with Sarbanes-Oxley requirements; quarterly operating and earnings releases; loan quality; reports from the Company's auditors, KPMG; accounting analyses; and internal audit presentations, including regarding audit plan development and a multi-year audit plan. One or more representatives of KPMG appear to have been present at all Audit Committee meetings.

The charter of the New Century Board of Director's Finance Committee provides that the purpose of that Committee "is to help discharge the responsibilities of the Company's Board of Directors . . . relating to the Company's financial performance, financial objectives and

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[238] New Century Financial Corporation Corporate Governance Guidelines (as amended and restated on July 26, 2006) at 2, *available at* http://www.ncen.com/pdf/corp_gov_guildelines.html; *see also* Form 10-Q for Q3 2006 at p. 54; Proxy Statement, Apr. 4, 2006, p. 32 ("Our governance and nominating committee also seeks to ensure that at least a majority of the directors are independent under any applicable legal and regulatory standards"); Proxy Statement, Apr. 11, 2005; Proxy Statement, Aug. 16, 2004.

[239] *See also* Proxy Statement, filed Apr. 4, 2006.

[240] *Id.* at 26; New Century Financial Corporation Corporate Governance Guidelines (as amended and restated on July 26, 2006) at 6.

[241] Form 10-Q for Q3 2006 at 54; New Century Financial Corporation Corporate Governance Guidelines (as amended and restated on July 26, 2006) at 6.

strategies, capital structure, financing strategies, liquidity, interest rate risk management, loan reserves and performance, acquisitions and divestitures and major financial initiatives." The members of the Finance Committee from its creation in early-2006 through the Company's bankruptcy filing were Alexander (Chair) and Zona, Sachs and Einhorn.

The Finance Committee met slightly more often than monthly. Among the types of issues the Committee discussed and the reports the Committee received were the following: liquidity forecasts; Management's financial models; alternative financial scenarios; and presentations by third-party financial advisory firms.

Finance Committee members said in interviews during the Examiner's investigation that one of the purposes of the Finance Committee was to build a more rigorous financial presentation to the Board as a mechanism to improve its ongoing monitoring of New Century's performance. Committee members also said that the Board wanted to have more time devoted to the analysis of strategic business risks and opportunities than what was feasible at the Board meetings, when there was insufficient time for detailed inquiry on financial presentations. Finance Committee members said that the new format for internal financial reporting developed by the Committee allowed the Board to receive financial information on a more regular basis, and in a format that permitted more time for strategic discussions.

3. Board of Directors Activity Level and Issues

New Century's Board of Directors appears to have met, on average, approximately two and a half times per month from early 2005 through early 2007. The Board also appears to have been very actively involved in many aspects of the Company's business and issues. Several interviewees indicated during the investigation that the Board asked very detailed questions about matters presented to it. One member of New Century's Senior Management described the Company's Board of Directors as having been "extraordinarily" active.

By late-2005, the Board had focused on several issues central to New Century's business, including concerns about the strengths and structure of the members of the Company's Senior Management, the strategic direction of the Company, the capabilities of New Century's Finance/Accounting Department, and the need for improvement in the Company's forward - looking financial projections. Ultimately, and as described in more detail below, the Board held an "off-site" meeting in January 2006 to address some of these concerns, and decisions were made to (1) change the Company's CEO structure from the existing "troika" of the Company's

founders, (2) appoint Morrice as the sole CEO, and (3) review the advisability of the "portfolio" strategy that the Company had been pursuing since before its REIT conversion in 2004.

In addition to these very significant matters, New Century's Board was considering many other important issues at various times, and sometimes many or all at the same time, during the late-2005 through early 2007 time period, including:

- replacing Dodge as Chief Financial Officer ("CFO");
- addressing the Company's liquidity position and concerns;
- standardizing and improving the Company's internal financial reporting mechanism;
- loan quality issues;
- imbedded credit risk issues regarding loans in the Company's portfolio;
- secondary marketing issues (including a possible conflict inherent in the "dual role" of Kevin Cloyd, head of New Century's Secondary Marketing Department);
- reviewing accounting issues in areas that required Management's judgment, such as loan loss reserves, loan repurchase reserves and residual interest valuations;
- reviewing the Company's financial reports and information disclosed to the public; and
- dealing with the Company's largest shareholder, David Einhorn, who, in 2006, became a member of the Board.

The Board's ultimate resolutions or actions regarding many of these various issues are discussed elsewhere in this Final Report.

4. Executive Management and Other Key Personnel

New Century's top executive was the President and CEO. One of the Company's founders, Cole, held those positions nominally from the founding of the Company through June 2006. However, as indicated above, Cole, Gotschall and Morrice effectively functioned as a CEO "troika" for New Century from the Company's inception until January 2006. Pursuant to the Board's decision in early 2006, Morrice who apparently, in substance, had been overseeing most of New Century's business already became the Company's President and CEO in June 2006, and he held that position until the Company terminated his employment in June 2007.

The top-level executive officers of the Company who reported to the President and CEO in the 2005 through 2007 time frame were the following:

Position	Name
EVP, Chief Financial Officer	Patti Dodge (until Nov. 2006)
	Taj Bindra (after Nov. 2006)
EVP; President, New Century Capital Corp. (the Secondary Marketing Department)	Kevin Cloyd (after Dec. 2005)
EVP, Production	Anthony Meola (after May 2006)
President, New Century Mortgage Corp.	Patrick Flanagan (until Dec. 2005) (upon Flanagan's departure from the Company in Dec. 2005, this position was split into the positions held by Cloyd and, a few months later, Meola)
EVP, Investor Relations	Patti Dodge (after Nov. 2006)
EVP, Chief Operating Officer	Brad Morrice (until June 2006)
	Joe Eckroth (after June 2006)
EVP, Corporate Affairs and General Counsel	Terry Theologides
SVP Leadership and Organizational Development	Robert Lambert

Each of these senior corporate officers, in turn, had a number of direct and indirect reports, including the following that are most relevant for purposes of this Final Report (in last name alphabetical order):

Name	Position	Reported to
George Arambula	VP, Internal Audit	Paul Zalle
Paul Atkinson	VP, Risk Solutions	Lenice Johnson
Eric Bachelor	Capital Markets Department	Evan Mitnick
Mark Bernstein	Trading Director	Rick Holguin
Ron Brown	Internal Audit	Paul Zalle
Ron Brown	Secondary Marketing/Repurchase Desk	Warren Licata, Rick Rhinehart, Karl Weiss
Richard Cimino	President, Loan Servicing	Kevin Cloyd
Dan Coakley	VP, Credit and Operations	Serene Russell
Rick Collins	Investor Reporting Manager	Evan Mitnick
Christine Fidler	VP, Corporate Finance	Rod Colombi
Amanda Fowler	Asst. VP, Investor Relations	Carrie Marelli
Carol Franchi	Asst. VP, Loan Accounting Manager	Tony Sanchez, Dave Kenneally, Donna Walker
Jeff Goldberg	VP, Treasurer	Rodney Colombi, Patti Dodge, Taj Bindra
John Hatch	Sr. Analyst, Secondary Marketing	Warren Licata
John Hedlund	SVP, Corporate Operations	Joe Eckroth
Jennifer Jewett	Corporate Counsel	Monika McCarthy
Lenice Johnson	SVP, Corporate Credit Officer	Kevin Cloyd

Name	Position	Reported to
Dave Kenneally	SVP, Controller	Patti Dodge, Taj Bindra
Tim Lee	Retail Underwriting	Gary Bellmore
Steve Lemon	EVP, East Coast Wholesale	Tony Meola
Robert Lent	VP, Investor Relations	Karl Weiss
Warren Licata	SVP, Secondary Marketing and Capital Markets	Karl Weiss, Kevin Cloyd
Mary Malloy	VP, Hedging	Karl Weiss
Carrie Marelli	VP, Investor Relations	Patti Dodge
Monica McCarthy	SVP Legal Counsel	Terry Theologides
Lois McDermott	Risk Manager	Rey Topete
William McKay	SVP Mortgage Operations	Dan Sussman, John Hedlund
Evan Mitnick	SVP, NCCC	Kevin Cloyd
Matthew Mullins	Sr. Analyst, Secondary Marketing (until 4/06); Hedging Dept. (after 4/06)	Warren Licata, Mary Malloy
Rick Rhinehart	VP Secondary Marketing	Kevin Cloyd
Tony Sanchez	Assistant Controller	Dave Kenneally
Music Sprouse	Cash Management Manager	Dave Kenneally
Randy Stewart	EVP, Home123 Capital Markets	Kevin Cloyd
Jonathan Threadgill	President, Retail Prime	Tony Meola
Joe Tortorelli	Legal Dept.	Terry Theologides
Donna Walker	VP, Financial Reporting	Patti Dodge, Dave Kenneally
Karl Weiss	SVP, Capital Markets	Kevin Cloyd
Colleen Wolf	Chief Information Officer	Joe Eckroth
Paul Zalle	SVP, Internal Audit	Terry Theologides

5. Management Committees

New Century's Senior Management participated in several Management-level committees, including the following: Asset and Liability, Cash, Credit, Disclosure, Executive Management, Liquidity, Securitization and Sub-Credit. Several of these committees were formed after the Company converted to a REIT in 2004.

6. New Century's Bonus and Incentive Compensation Plans

New Century's Senior Management received base compensation, bonuses and incentive compensation from the Company based on their employment contracts with the Company and pursuant to the provisions of the Company's "2004 Performance Incentive Plan" (the "2004 Plan").[242] The 2004 Plan was administered by the Compensation Committee of the Company's

[242] Proxy Statement, Apr. 4, 2006, at 43-45.

Board of Directors and, to a lesser extent, by the Board's Stock Option Committee.[243] These Committees, as administrators of the 2004 Plan, had broad authority to select the participants in the 2004 Plan and to determine the types of awards they would receive. The types of awards authorized under the 2004 Plan included stock options, stock appreciation rights, restricted stock, stock bonuses and cash bonuses. The administrators of the 2004 Plan could also grant performance-based awards, which depended on the absolute or relative performance of the Company or a subsidiary, segment, division or business unit. As of April 2006, essentially all of New Century's approximately 7,200 employees were considered eligible under the 2004 Plan.[244]

For 2005 and 2006, Cole, Morrice and Gotschall were each granted an award under the 2004 Plan that paid them a bonus based on the ratio of New Century's pre-tax net income to the Company's average stockholder's net equity. That bonus was measured and paid over a six-month and a 12-month period each year.[245] Generally, the higher New Century's pre-tax net income above a certain threshold, the higher the bonuses to Cole, Morrice and Gotschall, up to certain stated maximums based on their base salaries.

Quarterly bonuses were awarded to the Company's officer-level Management under the 2004 Plan. For most officers, these bonuses were based on several factors, including Company performance and, in most cases, attainment of personal performance goals. These different factors were identified in personalized "Bonus Schedules" at the beginning of each quarterly bonus period. Generally, the most significant bonus factors for senior managers were tied to Company or Department performance. Evaluations of individual performance goals comprised a smaller component for the most senior Management.

Many employees also participated in profit-sharing under the 2004 Plan. Each profit-sharing plan participant would receive a "factor" based on his or her annual salary. The plan included a formula for adjusting this factor up or down depending on how New Century's actual pre-tax income compared with targeted pre-tax income. The participant's "bonus benchmark" was the adjusted factor of his or her annual salary. Managers could adjust these benchmarks up or down before authorizing the actual bonus payment. If New Century did not reach a certain percentage of its target, however, no one could receive a bonus under this plan.

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[243] *Id.* at 12.

[244] *Id.* at 13.

[245] *Id.* at 44.

New Century also offered long-term incentive compensation with time-vested options to executives at the Assistant Vice President level and above. In March 2005, New Century introduced a new long-term incentive approach by awarding executives at or above the Vice President level different combinations of the following under the 2004 Plan.

- "Performance Accelerated Stock Options," which would vest when New Century stock hit a designated price;
- "Performance Accelerated Restricted Stock," which vested when New Century reached consolidated pre-tax earnings targets;
- "Dividend Equivalent Rights" ("DER"), which New Century based on its cash dividends; and
- For division heads in the loan production and servicing areas, "Performance Units," which vested if New Century's taxable REIT subsidiary reaching pre-tax earnings targets.

The total cash compensation, including bonuses, received by New Century's five most senior executive officers in 2005 was as follows:[246]

2005					
Name	**Salary**	**Bonus**	**DER Payout**	**Other**	**Total**
Robert Cole	$569,250	$1,070,235	$230,113	$5,700	$1,875,298
Brad Morrice	$569,250	$1,070,235	$230,113	$40,627	$1,910,225
Edward Gotschall	$569,250	$1,070,235	$230,113	$4,740	$1,874,338
Patrick Flanagan	$577,500	$1,120,235	$230,113	$7,000	$1,934,848
Kevin Cloyd	$300,000	$1,546,786	$104,598	$67,325	$2,018,709

In addition to these cash amounts, these five men received in 2005 the following restricted stock awards and securities underlying the stock options granted to them, neither of which vested immediately and both of which were subject to certain vesting conditions, including remaining with the Company for a certain number of years after the grant of the award:[247]

[246] Proxy Statement, March 16, 2006.

[247] *Id.*

2005		
Name	**Restricted Stock Award**	**Securities Underlying Options**
Robert Cole	15,628 shares	39,568 shares
Brad Morrice	15,628 shares	39,568 shares
Edward Gotschall	15,628 shares	39,568 shares
Patrick Flanagan	21,566 shares	39,568 shares
Kevin Cloyd	7,104 shares	17,986 shares

Each of these men also realized the following values on New Century stock options they exercised during 2005:[248]

- Robert Cole: $12,757,558
- Brad Morrice: $13,304,850
- Edward Gotschall: $13,942,208
- Patrick Flanagan: $2,585,274
- Kevin Cloyd $517,615

New Century did not file a Proxy Statement with the U.S. Securities and Exchange Commission ("SEC") in 2007. As a result, the information that would have been reported regarding compensation and bonuses paid to the Company's most senior executives in 2006 is not as readily available as it was for 2005. However, in anticipation of the preparation of compensation disclosure information for the Proxy Statement the Company was planning to file in 2007, New Century attorneys prepared a memorandum to the Compensation Committee, dated January 31, 2007, that had as an attachment a "Summary Compensation Table" detailing compensation, bonus, stock award and other information for the seven most senior executives of the Company for 2006. With the exception of the bonus figures, the following information is taken from the attachment to that memorandum, which noted "that the attached documents are a work-in-progress and are subject to ongoing review and comment. In addition, some of the data required to update the tables for fiscal year-end is not yet available" (numbers in brackets appear in original and may be some of the information that, according to the memorandum, needed to be updated):

[248] *Id.*

2006								
Name	**Salary**	**Bonus**[249]	**Stock Award**	**Option Award**	**Non-Equity Incentive Plan Compensation**	**Change in Pension Value and Non-Qualified Deferred Comp Earnings**	**All Other Compensation**	**Total**
Brad Morrice	$657,647	$693,016	$674,988	$115,654	[$880,254]	[$1,684,552]	[$75,436]	[$4,088,532]
Robert Cole	$663,958	$693,016	0	0	[$871,234]	[$2,844,418]	$11,182	[$4,390,792]
Tajvinder Bindra	$69,231	0	$535,650	0	[$190,217]	0	$1,000	[$796,098]
Patti Dodge	$307,692	$464,232	$283,514	$53,174	[$646,578]	0	[$62,577]	[$1,353,535]
Kevin Cloyd	$307,692	$1,034,229	$330,747	$62,035	[$1,366,188]	0	[$92,584]	[$2,159,246]
Anthony Meola	$323,718	$453,125	$2,197,179	$285,751	[$640,625]	0	[$17,594]	[$3,464,867]
Joseph Eckroth	$319,463	$471,320	$425,252	$79,756	[$652,450]	0	[$37,305]	[$1,514,226]

7. New Century's Auditors - KPMG

New Century retained KPMG as its outside auditors when the Company was formed in 1995. KPMG served as New Century's outside auditors until April 27, 2007, when KPMG resigned as the Company's auditors. At that time, KPMG had not yet completed its audit work in connection with New Century's 2006 Annual Report or the Company's announced restatement of its 2006 quarterly financial Reports.

KPMG's audit reports of New Century's consolidated financial statements for the years ended December 31, 2004 and 2005 did not contain any adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.[250] Further, the audit reports of KPMG on Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004 and 2005 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.[251]

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[249] The information contained in the Bonus column is taken from Compensation Committee minutes for meetings on October 30, 2006 and January 31, 2007.

[250] Form 8-K, April 27, 2007.

[251] *Id.* The Form 8-K notes that KPMG did not include newly acquired RBC Mortgage in its audit of internal control over financial reporting in 2005.

F. Analysts Reports and Comparisons to Other Companies

As indicated above, one aspect of the corporate culture at New Century appears to have been a sense that the Company was better than its competitors. That sense may have come, in part at least, from reports by securities analysts that indicated that New Century was doing certain things better than many of its competitors, at least for a time. The following are excerpts from illustrative analysts reports from mid-2005 into the first half of 2006:

- FBR (Aug. 5, 2005):

"At 1.89%, [New Century's] [loan] origination costs remain one of the lowest in our nonprime coverage universe, and second only to Accredited Home Lenders."

- Fox-Pitt, Kelton (Sept. 26, 2005):

"Based on available data, [New Century] is one of the lowest cost originators in the space, which is a good sign for their longer-term mortgage banking profitability.

Figure 2: Industry Loan Origination Costs

Originator	Period	Cost (%)
Ameriquest (retail)	2004	1.25%
Accredited	2Q05	1.73%
New Century	2Q05	1.89%
Argent	2004	1.92%
Aames	2Q05	2.33%
Fieldstone	2Q05	2.37%
Encore	2Q05	2.40%
Delta	2Q05	2.50%
Novastar	2Q05	2.61%
Option One	FY4Q05	2.65%
Saxon	2Q05	2.84%

We continue to believe [New Century] is among the best positioned in the industry to weather what we think will be an eventual shakeout in the space. The industry today remains highly fragmented with many players involved, many of whom were born in 2001-2004 era, a period when the Fed was aggressively cutting rates and creating a robust mortgage banking climate for even the most inefficient operators. Most of these originators are smaller, have less liquidity, and limited or not access at all to the capital markets. In addition, they lack an overall presence within the industry to effectively compete with the larger, more solidified originators such as New Century. We expect New Century to emerge from this cycle a stronger, more efficient operator."

- Goldman Sachs (Nov. 29, 2005):

"On the positive side, [New Century] has a leading cost structure as the 2nd largest subprime originator, decent liquidity, some added flexibility because of the size of its loan portfolio (related earnings stream and the ability to monetize some of those assets if need be), and a seasoned Management team (the top tier of executives has been in the subprime mortgage business for over 10 years). We see its relatively low cost structure as key, given the gain on sale margins today – a number of competitors with higher cost bases appear to be under water on recent originations."

- Fox-Pitt, Kelton (Dec. 1, 2005):

"New Century remains a behemoth in the subprime space, a market which is growing and consolidating. The company's origination platform, scale, market depth and overall presence in the asset-backed community is matched by few in the industry. We remain optimistic New Century will emerge from the cycle a stronger, more efficient, and better capitalized financial institution."

- JP Morgan (Dec. 22, 2005):

"With gain-on-sale margins down 100-200 bps, as mentioned above, [New Century's] low cost to produce provides the company with a competitive advantage. . . . Looking forward, we expect to see the company maintain and possibly slightly improve its cost to produce as lower-cost retail origination (via the RBC acquisition) becomes a larger part of [New Century's] business."

- Stifel Nicolaus (Jan. 12, 2006):

"That is not to say, however, that we are bearish on the franchise. On the contrary, we have been surprised that, despite the company's aggressive growth, we have found little evidence of deterioration in underwriting and [New Century's] credit trends remain above industry averages. Based on securitization data, we find consistent evidence that [New Century's] securitizations outperform most competitors in both 2003 and 2004 vintages."

- UBS (Apr. 12, 2006):

"We believe New Century remains well positioned to withstand continued competitive pressures within the subprime mortgage origination sector for several reasons:

Unlike several other players that have had issues with reducing costs, New Century has successfully reduced its loan acquisition costs by over 60 bps [basis points] in 2005. . . .

New Century has one of the best reputations in the secondary market given its leadership position and stronger balance sheet versus some of its peers. In a market where there are increasing concerns that some players may have problems sustaining their franchises, bidders in the secondary market may bid up New Century product to ensure they have a reliable product supply for their securitization business."

- FBR (May 5, 2006):

"Cost to originate (CTO) impresses. [New Century's] CTO of 1.66% was significantly below our estimate of 2.00% and essentially flat with 4Q05. Going forward, we expect its CTO to remain lower than industry averages . . . ."

On the other hand, many of these same analysts expressed concerns and caution about, and drew unfavorable comparisons regarding, New Century, beginning in the second half of 2005 and especially into 2006, as indicated below:

- Fox-Pitt, Kelton (Aug. 9, 2005):

"[New Century's] [g]ain on sale revenue came in $139 million, well below our estimate of $160 million. The gross gain on sale margin dropped 47 bps to 2.28%, well below our 2.75% estimate. . . . Based on reported 2Q05 results from Accredited Home Lenders . . . and Fremont General . . ., which reported gross GOS margins of 3.15% and 2.75%, respectively, New Century whole loan packages traded at a discount to its peers during the quarter. Although stiff price competition appears to be the main culprit (i.e., coupons have not risen in tandem with short-term rates) other factors contributed to drop in execution including: 1) a higher concentration of IO [interest only] loans (which increased to 37% of production from 33%). IO loans are worth less in the secondary market to due to harsher rating agency stresses, resulting in lower bids from whole loan purchasers. . . ."

- JP Morgan (Dec. 22, 2005):

"That said, with limited sources of funding and higher risk premiums being demanded for sub-prime mortgages, liquidity risk exists that could impugn [New Century's] ability to originate and replenish the portfolio, in our view. [New Century] trades at a 20% discount to the overall residential mortgage REIT group."

- Stifel Nicolaus (Jan. 12, 2006):

"However, [New Century's] credit quality looks less than stellar in 2005 as recent vintages appear to be seasoning poorly, at least relative to earlier vintages. Specifically, although it is too early to get meaningful data on loss rates, 2005 pool level delinquency rates look to be worse than most recent vintages. While this could be attributed to slowing housing appreciation and/or a weakening consumer, we think it more likely reflects the underwriting deterioration that we noted above, i.e., lower FICO stated income loans. . . . As a result, although we have generally been impressed with what we have found on the credit side, recent vintages don't appear to be as strong. Combined with the fact that these loans will likely season in a weaker housing environment, it serves to undermine our level of comfort with [New Century's] credit quality. . . . Although we believe [New Century's] underwriting has held up over the last couple years, we believe it is more exposed than others in the sector to deteriorating subprime credit quality due to its high concentrations in CA, IO, and stated income loans."

- JMP Securities (Sept. 29, 2006):

"[W]e looked at vintage 2003, 2004, 2005 and 2006 [loan] pool data for a number of sub-prime lenders in our coverage universe and found that [New Century's] pools generally showed higher levels of asset quality deterioration as measured by the sum of seriously delinquent and foreclosed loans.... The above-peer deterioration noted in [New Century's] pool suggests that stressed economic conditions could and likely would serve to further weaken the performance of [New Century's] loan assets.... One indication that [New Century] may experience default rates higher than its competitors was its significant increase in 2Q06 loan repurchases. Knowing that EPD (early payment default) repurchases only pertain to whole loan sales of mortgages that have defaulted, or will imminently default . . . the fact that loan repurchases for [New Century] were $415 million in 2Q06, up 350% from 1Q06, could foreshadow increasing delinquency and loss rates. To compare, for 2Q06, IndyMac Bancorp Inc . . . repurchases were $101 million (up 55% QoQ), Countrywide Financial Corp . . . repurchases were $34 million (up 173%) and Accredited Home Lenders Holding Co . . . repurchases were $39 million (up 164%). While we expect the EPD repurchase cycle to slow over the next 2-3 quarters, we do think the relatively poor performance of [New Century] versus other lenders may indicate that underwriting guidelines at [New Century] may have been more lax than at other lenders."

- JMP (Oct. 24, 2006):

"[W]hen we consider our previous finding regarding the weaker credit performance of [New Century's] [loan] pools relative to a select peer group . . ., it seems likely that [New Century's] credit performance will be similarly encumbered.... Moreover, it appears the vintages most susceptible to credit deterioration at this time are the 2005 and 2006 vintages, which we would contend are those that benefited most from increasingly more lax underwriting standards – standards that to our mind were ever more compromised by aggressive competition for market share.... Additionally, given the generally weaker credit performance of [New Century] loan pools versus pools from a select group of peers . . ., we believe certain of [New Century's] loans – specifically, HELOCs – could be predisposed to losses."

- FBR (Nov. 3, 2006):

"With one of the most heavily reserved and best performing players in the space recently cautioning that its 3.75%-4.25% cumulative loss rate assumption may prove to be too low, we are concerned with [New Century's] 3.30% and 2.83% projected cumulative loss expectations for 2006 and 2005, respectively. From our industry modeling, if historical roll rates are similar to those in 2001, given current speeds, we can appreciate how [New Century's] models may indicate loss experience in the low-3% range for the 2005 and 2006 vintages. However, given the risks associated with a meaningful slowdown in home price appreciation and risk layering that is by all accounts creating adverse credit performance, we believe historical roll rates may understate this risk. In a quarter where the

allowance for loan losses remained essentially flat at 1.4% (excluding the reserve for REO), we believe there is a risk that [New Century] will have to add meaningfully to the reserve in the future, given our divergence from Management with regards to loss expectations. We caution investors not to compare the reserve as reported in [New Century's] release across other issuers. The reserve of $239 million includes $47.8 million of a real estate owned reserve, which is traditionally carried in other assets. We believe the more appropriate measure is to look at the reserve excluding the REO reserve, as it conforms to reporting standards across the industry. Probably more immediate than a larger-than-expected reserve build is a residual impairment charge for the off-balance-sheet portfolio. Based on our analysis, these 2005 off-balance-sheet pools have a worse credit performance than the average managed 2005 vintage. Given our belief that [New Century's] cumulative loss rate assumptions could prove too low, the most likely credit risk to earnings is a residual write-down on these loans."

- Piper Jaffray (Dec. 12, 2006):

"[W]e are expecting [New Century's] credit stats on its securitized loans to worsen, especially on the '05 and '06 vintages. Historically, [New Century's] credit stats have been worse than the industry average. Although we believe that [New Century] has become a more conservative underwriter, we would like to see some more evidence of this in its credit trends."

G. Summary of Certain Significant Developments at New Century from 2005 through the Bankruptcy Filing in April 2007

This Final Report details a number of significant events and issues relating to New Century's accounting, corporate structure management, and business endeavors. The following significant developments will be discussed in greater detail throughout the report, but merit an introduction as background to the Examiner's findings.

1. Internal Audit Review of New Century Loan Processing Centers

During 2005, New Century's Internal Audit Department reviewed nine loan processing centers, including eight of the Company's 38 wholesale processing centers, and one of the three retail processing centers. Seven of the nine centers reviewed, including the retail center, received ratings of "Unsatisfactory." The remaining two received "Needs Improvement." The results of this review were presented to the Audit Committee and were brought to the Board's attention.

Members of the Audit Committee interviewed during the investigation said that, after reviewing Internal Audit's review of the loan processing centers, the Committee instructed Management to fix the problems identified in the review and instructed the Internal Audit Department to follow-up and monitor Management's efforts in this area. The Audit Committee

also requested that Management to provide updates regarding New Century's "loan quality and compliance plan" at future Committee meetings, which Management did.

2. Departure of Patrick Flanagan

On December 27, 2005, New Century announced that Patrick Flanagan, who had been the Head of Loan Production and Secondary Marketing, would take a six-month leave of absence beginning January 1, 2006, after which his employment would terminate.[252] Beginning July 1, 2006, Flanagan would continue to receive $76,445 per month in compensation for an additional 18 months pursuant to a "Consulting Agreement" with New Century.[253]

Flanagan had joined New Century in 1996 as the Regional Vice President of Midwest Wholesale and Retail Operations. In 1997, he was promoted to Chief Operating Officer ("COO") of NCMC and relocated from Chicago to California. As COO, Flanagan supervised New Century's mortgage loan origination processes, including the credit and underwriting functions, secondary marketing activities, the quality control process, and the Company's information technology infrastructure for loan originations. In February 2002, Flanagan became the President of NCMC and he continued to head New Century's production and secondary marketing activities. From 2002 through his departure at the end of 2005, Flanagan reported directly to Morrice.

In his interview during the Examiner's investigation, Paul Zalle, head of the Company's Internal Audit function, said that Flanagan emphasized maintaining New Century's loan production even when field audits revealed loan quality problems. Although Zalle believed that Flanagan considered loan quality concerns, he did not believe that Flanagan gave those quality concerns as much weight as Flanagan gave to loan production volume considerations. Information from interviews conducted during the investigation suggests that the Company's emphasis on volume continued after Flanagan's departure from New Century.

According to interviewees, Flanagan's last day at New Century's offices was December 5, 2005. Interviewees cited concerns ranging from distractions in Flanagan's personal life to disagreements over the Company's business strategy as factors that may have contributed to Flanagan's departure. Several interviewees noted that they perceived a rift between Morrice and Flanagan. For example, Flanagan himself and other interviewees said that Flanagan disagreed

[252] Form 8-K, Dec. 27, 2005.

[253] *Id.*

strongly with the stock repurchase plan adopted by the Board, with the agreement or acquiescence of Morrice, in November 2005.

3. Resignation Letter Drafts by Richard Zona

On or around November 1, 2005, Board member Richard Zona drafted a letter to the New Century Board announcing his immediate resignation, but he did not in fact resign. He drafted a similar letter dated December 6, 2005, but, again, he did not resign from the Board. It is not clear with whom Zona shared these drafts, if anyone, however, he never sent either letter in final form to the full Board of Directors. There are significant differences between Zona's two draft resignation letters, but both drafts address the principal concerns Zona had about New Century's (1) Management, (2) financial reporting and (3) strategy to build a portfolio of loans rather than continue whole loan sales.

There are cosmetic and substantive differences between the two draft resignation letters. The November letter, for example, is slightly shorter and does not have a signature line. The November letter also discusses many more details of New Century's interactions with Einhorn and input from Third Point, which owned approximately 3.6% of New Century's shares. Einhorn and Third Point requested that New Century take steps to "maximize shareholder value," including a share repurchase program. Zona's December letter leaves out many of these details.

The December 6, 2005 draft resignation letter refines some of the material from the November draft relating to Zona's three principal concerns, but also includes additional criticisms of Management. The following quotes from Zona's December 2005 resignation letter are illustrative of his concerns (some of these points are also expressed in his November draft):

- "[I]t was wrong for Management to previously lead us to believe that our shareholders were strongly in favor of the balance sheet strategy and conversion to a REIT when they knew that our largest shareholder was opposed to the balance sheet strategy."
- "The Current Management team appears to be dysfunctional. We have gone from Management telling us a short time ago that Pat Flanagan is a star and therefore he was promoted to a "full partner," to a person that is being terminated effective immediately."
- "In my view, Ed [Gotschall] does not respect the outside directors, has displayed unacceptable and highly immature behavior and is a disruptive force within the Company. . . . Further, he has displayed intransigent positions, which are not supported by hard analysis."

- "Bob Cole does not appear to be fully engaged and has to assume responsibility for the dysfunctional Management team."
- "[T]he Board concluded that the Company should let the portfolio run down without replacement . . . and that a buy back of 5,000,000 shares should be pursued, subject to liquidity requirements. This was clearly an initiative pushed by the Board as evidenced by Ed Gotschall's emotional opposition to the buyback, while Bob Cole was largely silent and was thought to have voted for the buyback proposal; while latter [sic] he stated that he had abstained from the vote."
- "For several days subsequent to the Board meeting, Management constructed barriers to implementing the Boards [sic] decisions instead of determining the best way to implement them."
- "Also at the October 25th and 26th Board meeting, Management informed the Board that its current forecast and analyst consensus for third quarter EPS of $2.24 per share could not be achieved unless Management reversed $.26 per share of loan loss reserves. . . . Obviously, Management's desire to reverse reserves in the third quarter smacked of earnings manipulation."
- "Management's use of off balance sheet gain on sale accounting substantially overstates earnings when compared to cash flows, thus generating extremely aggressive income recognition."
- "Our largest shareholder has questioned the appropriateness of our accounting for loan losses."
- "[Regarding questions about New Century's hedging strategies] It's hard to believe that this all this [sic] just happened since the Board began questioning the use of Euro futures instead of [interest rate] SWAPS. It would seem that Management is trying to spin this so as to not appear that they intentionally overstated earnings or simply missed this."
- "As to accounting for loan losses, it is a long standing accounting maxim that accounting should be designed and applied to match revenues and expenses. Management's methodology to provide for loan losses based upon their estimate of charge offs over the next 18 months does not accomplish that objective. . . . Management's methodology does not result in a proper matching of revenues with costs, (loan loss provisions), because charge offs are back ended."
- "From day one, I was skeptical of the proposal by Management to adopt a portfolio strategy and build a balance sheet, which would result in our assuming incremental credit, interest rate and prepayment risks that a whole loan sale strategy would avoid. . . . However, because of Management's strong, forceful recommendation, I did not vote against this strategy. It is much clearer to me now, that the portfolio strategy encompassed in our hybrid REIT is the wrong strategy and that we should either de-REIT or spin off the REIT or TRS."

In his interview during the investigation, Zona said he never submitted his resignation from the New Century Board because other independent Board members persuaded him to wait

to see whether the expected management changes to be discussed during the Board's January 2006 "off-site" meeting would alleviate his concerns.

4. Efforts to Sell the Company

As early as December 2005, representatives of a large securities firm approached Cole to discuss whether New Century would entertain a bid for the Company. On January 25, 2006, New Century Management met with representatives of the securities firm to discuss further a possible acquisition of the Company. New Century engaged a large investment bank to analyze the value of the Company and determine whether other companies would have an interest in purchasing New Century. The potential sale of the Company at this time was referred to within New Century as Project 2000.

In February and March 2006, in connection with Project 2000, Management solicited expressions of interest to acquire New Century from two other large securities firms. Each of the three potential purchasers performed limited due diligence and presented New Century's Management with estimates of New Century's value. By April 10, 2006, New Century received preliminary proposals of less than $50 per share from one of the potential purchasers, $54 per share from another potential purchaser, and $51 to $55 per share from the third. New Century continued discussions with these potential purchasers through May 2006, but did not consummate a sale of the Company under Project 2000.

5. Brad Morrice Becomes CEO

As mentioned above, on January 9 and 10, 2006, New Century's Board of Directors had an "off-site" meeting which the Board agreed, among other things, to restructure the Company's CEO position and formally transition Morrice into the position of CEO. On March 29, 2006, New Century and Morrice executed an Amended and Restated Employment Agreement. Pursuant to this agreement, Morrice served as Vice Chairman and President of New Century and, commencing on July 1, 2006, CEO of the Company. Until July 1, 2006, Morrice continued to serve as Chief Operating Officer.

The January 2006 off-site Board meeting came after what interviewees described as a very difficult year for New Century. Throughout 2005, the Company faced external pressures as interest rates rose, home prices leveled off, competition increased and the market for MBS declined. Internally, a rift had developed between Management and some Board members regarding several significant issues (including New Century's REIT portfolio strategy),

Flanagan's departure forced Management to reorganize his direct reports, and New Century's largest shareholder, Einhorn, was threatening a proxy contest. The New Century Board invited Dr. Vance Ceasar, Ph.D. to its January 2006 off-site meeting to help the Board and the Company's Senior Management improve their relations and address corporate governance. With Dr. Ceasar's facilitation, the Board and Management developed five broad initiatives, one of which was the promotion of Morrice to CEO while keeping Cole in place as the Board's Chairman.

Other initiatives the Board adopted during the January 2006 off-site meeting and pursued over subsequent months included the following:

- Morrice was tasked with reviewing existing Management, creating a Senior Management succession plan, and addressing specific leadership requirements and talent acquisition needs.
- The Board and Management determined to agree on common business strategies for the near and long-term.
- The Board agreed to create a Finance Committee to address financial strategy with Management and improve Board-Management communication.
- The Board decided to evaluate adding someone with structured finance expertise to the Board.

According to interviewees, even though he did not formally assume the CEO position until July 1, 2006, Morrice effectively functioned as New Century's CEO from the time of the January 2006 off-site meeting forward. As noted above, Cole said in his interview during the investigation that the operational side of New Century had reported to Morrice when he was the Company's COO; Cole said that. when he was CEO, Cole was only responsible for investor relations.

6. David Einhorn Goes on the Board of Directors

On March 31, 2006, Einhorn joined New Century's Board of Directors pursuant to an agreement reached among New Century, Einhorn and several entities Einhorn controlled. At that time, Einhorn and entities he controls were the largest single shareholder in New Century and they held approximately 9.8% of the common stock of the Company as of March 1, 2006.[254] The agreement between Einhorn and New Century followed a year of discussions between

[254] 2006 Proxy Statement at 35.

Einhorn and the Company's Board and Management, and the agreement avoided a pending proxy contest.

More specifically, on March 23, 2005, about a year before joining New Century's Board, Einhorn's company, Greenlight Capital, filed a Schedule 13D/A stating that Einhorn held beneficial ownership of 9.1% of New Century's common stock and expressing dissatisfaction with New Century's efforts "to enhance shareholder value."[255] Over the course of the following year, Einhorn apparently had regular contact with members of New Century's Management and independent Board members, such as Zona.

On August 4, 2005, Einhorn presented his views and concerns directly to New Century's Board. In that meeting, Einhorn distributed a PowerPoint presentation that included the following comments, among other points:

- "[Einhorn's] communications with the CEO have not been effective;"
- "We are worried that New Century will destroy further per share value under its current strategy;"
- "[New Century's loan origination business had] all cash gain on sale, [was] not capital intensive, [and had] no retained credit exposure;"
- "We suggested to sell loans and buy back stock . . . the result of an aggressive share repurchase strategy would have been substantial per share value creation for shareholders;"
- "Instead, [New Century] "bought loans and sold stock;"
- "In early 2003, Management elected to pursue a strategy of securitizing loans onto its balance sheet;"
- "Management had difficulty justifying the on-balance sheet election when challenged;"
- "[The portfolio strategy] [h]as left the company as a levered, large holder of credit risk into what many say is a housing bubble;"
- "[The portfolio strategy] [h]as forced New Century to rely on aggressive accounting;"
- "History of Poor Decision making – Management does not seem to understand what drives value, [e.g.,] on balance sheet strategy, Aggressive Accounting;"
- "Significant Management stock sales – Recent sales signal lack of confidence to investors, particularly in light of liquidity from REIT dividends;"

[255] Greenlight Capital, L.L.C., Schedule 13D/A, April 28, 2005.

- "Lack of investor confidence in CEO – Many investors and prospective investors have issues with Bob Cole;"
- "Origination franchise is a volatile, low cost, fast growing, not-very-capital-intensive, enormous ROE, cash generating machine;"
- "Loan portfolio is a highly levered, credit risk and duration risk intensive, capital intensive, tax efficient, steady earnings generating machine."

For several months after this presentation, Einhorn apparently continued his discussions with New Century's Board and Management. During this time period, as discussed above, Board member Richard Zona became disillusioned with and critical of some members of Management and considered resigning from the Board.

By February 2006, Einhorn made two requests: (1) that he be given a seat on the Board of Directors; and (2) that Greenlight receive an exemption from the 9.8% stock ownership limit in New Century's charter. On February 14, 2006, New Century offered Einhorn some concessions, but rejected his request to become a director. In response, on February 17, 2006, Einhorn filed another Schedule 13D/A announcing his intention to nominate an alternative slate of directors at New Century's 2006 annual meeting of stockholders.[256]

On March 6, 2006, New Century's Board of Directors authorized a settlement with Einhorn granting him an exception to the 9.8% ownership limit in New Century's charter, and agreeing to give him a seat on the Board of Directors effective March 31, 2006. All of the directors voted in favor of this settlement except Cole, who voted against it. According to Einhorn, he joined the New Century Board earlier than he planned in order to assist the Company in considering the purchase offers that had been received from potential buyers in connection with Project 2000. Einhorn reportedly was less in favor of pursuing the sale of the Company to these potential buyers than were Cole, Gotschall and others.

After serving for slightly less than a year on New Century's Board of Directors, Einhorn resigned from the Board of Directors effective March 7, 2007.[257]

7. Management Concerns About Weaknesses in Accounting and Financial Forecasting

In 2006, members of New Century's Senior Management were concerned about weaknesses in the Company's accounting and financial forecasting capabilities. Those concerns

[256] Greenlight Capital, L.L.C., Form SC 13D/A filed by February 17, 2006.

[257] Form 8-K, March 2, 2007.

caused the Company to determine that it should hire an accounting "geek in a box" to focus solely on accounting policy issues and GAAP accounting research and literature. Dodge indicated in her interview that she thought the Controller, Dave Kenneally, and the Assistant Controller, Tony Sanchez, had too many responsibilities at that time, including operational roles (e.g., accounts payable) and accounting roles (e.g., GAAP and financial reporting). Dodge also said that she was focused on succession planning and that she was grooming Kenneally to replace her as CFO and she wanted Kenneally to groom Sanchez to replace him as Controller. Dodge said that a "geek in a box" would have freed up Kenneally and Sanchez and make succession planning easier. Morrice said the "geek in a box" would have focused on new accounting issues, such as changes to the hedge accounting rules.

In e-mails, Morrice repeatedly expressed his frustration with New Century's financial information forecasting and dissemination abilities. For example, in a September 7, 2007 e-mail from Cloyd to Morrice and others, Cloyd attached a spreadsheet regarding loan repurchase claims and requests and said, "Clearly the attached suggests that we got our teeth kicked in with regard to repurchase requests in Aug[ust] and thus far in September." Morrice reacted to this information in a reply e-mail to Cloyd and Dodge:

> How can we find out about this just hours after we send a positive press release about this and after sending a positive report to the Board? And I even asked if we were sure we were comfortable! We have to get our act together and get way better coordinated on info sharing and warning lights. I am really tired of being surprised like this! It should be embarrassing to all of us. And that's just the insult, the injury is the economic impact.

In his interview during the investigation, Morrice said this e-mail reflected his frustration with the Accounting Department's financial forecasting capabilities.

Morrice again expressed his concerns about the strength and reliability of the Company's Accounting Department in a January 13, 2007, e-mail exchange with Taj Bindra, who had joined New Century as its CFO in November 2006. In his e-mail Morrice wrote: "Having just reviewed what Dave [Kenneally] sent out, I am even more dismayed. . . . Worse by far is seeing the stunning magnitude of the forecasting failure on the repurchase reserves and REO reserves. Despite our very public emphasis on these numbers, including the Board's demand that we pay very close attention to these numbers, and a December update that was supposed to reflect a hard look, the forecasts are off by $34 mil relative to base numbers of $18 mil." In an e-mail to Morrice later that day, Bindra wrote: "I continue to be equally dismayed by the lack of financial

discipline and accountability on the part of both finance and operating managers. In my mind not to have any visibility around the impact of the REO mark and the magnitude of the repurchase reserve increase very early in 4q is unacceptable. We should not be getting surprised in January with these rather large swings [in repurchase and REO reserve amounts]."

Morrice indicated in his interview during the investigation that, though there had been some progress with the Company's forecasting capabilities after the arrival of Bindra in November 2006 and the other changes made that year, there were still frustrating problems. Morrice believed that Bindra and Kenneally needed more and better quality staff, and Morrice said that he had hoped Bindra would hire new additional financial staff, something that had not been accomplished by January 2007.

8. Concerns About Kevin Cloyd's "Dual Role"

Certain members of the New Century Board and Senior Management expressed concerns in 2006 about Cloyd's credibility and about his responsibility for both selling mortgage loans in the secondary market and adding loans to the Company's own portfolio. The concern was that Cloyd might be selling the "better" loans in the secondary market and keeping in the Company's portfolio the loans that were not as easy to sell because they were riskier or were otherwise "bad" loans. In an August 18, 2006 e-mail from Einhorn to Morrice after Einhorn's interview of Bindra for the CFO position, Einhorn wrote that Bindra's "strongest comment was his worry about possible adverse selection in the portfolio created by the Kevin [Cloyd] conflict. He identified that issue and shared it without specific prompting from me." By the fall of 2006, Einhorn and others on the Board who believed Cloyd had a conflict in his dual roles pushed to identify this as an issue and address it by separating Cloyd's duties, but, by then, New Century was no longer securitizing mortgage loans. Accordingly, this conflict was not an issue that needed the immediate attention of the Board or the CEO, and it was never resolved.

9. Patti Dodge Replaced as CFO

On October 25, 2006, New Century hired Bindra as an Executive Vice President ("EVP") and the Company's CFO, replacing Dodge in that position.[258] Dodge, who, as described above, had joined New Century in 1996, became the Company's Executive Vice President for Investor Relations.[259] According to Board members interviewed during the investigation, New Century's

[258] Form 8-K, Oct. 30, 2006.

[259] *Id.*

Board had determined at some time in the spring of 2006 that Dodge should be replaced as CFO. It is apparent from contemporaneous documents made available to the Examiner that Dodge and Senior Management of New Century had been considering this transition by May 26, 2006 at the latest, which is the date of a memorandum from Dodge to Morrice outlining her transition to the investor relations role.

There are various accounts as to why Dodge was transitioned from CFO. Morrice suggested in his interview during the investigation that Dodge's strengths were in accounting and financial reporting rather than financial analysis and forecasting. He suggested that New Century's growth and goals warranted a more experienced CFO. Also, some members of New Century's Board of Directors, including Zona and Einhorn, had expressed doubts about Dodge's capabilities and competence to be the Company's CFO.

Some members of the New Century Board of Directors also apparently had doubts about Dodge's ability to represent the Company to its investors. In an October 2006 e-mail to fellow Board member Zona, Forster wrote, "I would hope you could hold off concluding that Patti [Dodge] is unfit to represent the Company to our investors. You may be correct, but as we agreed this morning, we should hear them out." On the other hand, Morrice said in his interview that he wanted to move Dodge to the investor relations role because of her good relationship with financial analysts and her "great institutional knowledge."

Dodge said in her own interview during the investigation that she had been prepared to leave New Century in May 2006, but that Morrice had persuaded her to take the investor relations position instead. Dodge said her long-term plan was to leave business and teach elementary school. She had indicated in her May 2006 memorandum to Morrice that the transition from the CFO role to the investor relations role was "potentially a step in that direction."

10. Creation of Repurchase Desk

In an effort to create a more centralized and effective tracking system for repurchase claims, New Century created a loan "repurchase desk" in the fall of 2006. Ron Brown in the Secondary Marketing Department ran the repurchase desk, which served as a central point of contact for New Century and its investors for all repurchase requests. It recorded, tracked and reported to Management on the status of repurchase claims. It also facilitated the processing of repurchase claims that were agreed to by New Century.

11. New Century's Liquidity Crisis

New Century experienced a severe liquidity crisis in August 2006. According to its Form 10-Q for the third quarter of 2006, "[t]he minimum level of liquidity currently required under [New Century's] credit facilities is $134.4 million."[260] However, on August 24, 2006, Morrice reported the following in a memorandum and attachment to the Company's Board: "At June 30, 2006, New Century had approximately $380MM in total liquidity. As of August 18th, New Century's total available liquidity was estimated at less than $50MM." Morrice said further: "The decrease in liquidity is attributable to a variety of factors, some of which are seasonal, and some of which are one-time in nature." He went on to list the "categories" of the causes of the decrease in liquidity, which were "typical intra-quarter cash flow patterns as loan originations has [sic] outpaced loan sales quarter-to-date," "continued difficult secondary market conditions leading to warehouse line margin calls, higher 'investor kick-outs,' and loan repurchases," and "mark-to-market on New Century's Euro dollar hedges."

Morrice went on to say, "We view the current liquidity position as short-term in nature," and he estimated that "available liquidity at the end of the 3rd quarter [would] increase back to $300MM-$350MM." However, he also recommended "exercising caution in spending on significant discretionary items such as share repurchases until available liquidity increases back above $300MM." He also said the Company was exploring "other vehicles to improve liquidity, such as an unsecured revolving credit facility," and that they were "also working with our warehouse lenders to expand facilities and/or improve financing rates and we are reviewing our collateral delivery processes to reduce the number of loans we finance with our own cash."

New Century Board members reacted with concern to this information. Forster had the following reaction in an August 25, 2006 e-mail to other Board members:

> The low liquidity event of last week is concerning. It seems that a lot went wrong, including the correlation of risks that we sometimes think of as NOT correlated. With falling rates one might think that the painful hedge margin calls might be offset by somewhat better secondary execution and a friendlier warehouse line advance policy environment—the reverse occurred. The expectation of lower loan volume, credit challenges and a tougher secondary market seems to be growing both outside and inside [New Century]. In any case a lot seems to be working against us now and we must be cautious not to put the company at risk.

[260] Form 10-Q for Q3 2006 at 69.

> Of equivalent concern is the lack of warning—this operational/liquidity challenge, from my point of view, seemed to dump upon us with no specific prior indication of a pending problem. We seem to be living in a volatile world without terrific tools to respond constructively.

New Century's Board of Directors and the Finance Committee of the Board monitored the Company's liquidity in the fall of 2006, as market conditions became more aggravated. New Century's efforts to address its liquidity crisis in the late summer and fall of 2006 included two capital raising transactions: (1) the completion of a $50 million private placement of trust preferred securities on September 13, 2006,[261] and (2) the completion of another private placement of trust preferred securities in the amount of $35 million on November 17, 2006.[262] Following the first of these capital raising transactions, in September 2006, New Century spent more than $41 million to repurchase its own stock. The Company's liquidity challenges continued throughout the remainder of 2006 and into early 2007.

12. Project Kettlebell

As indicated above, throughout 2006 New Century's Board and Senior Management re-evaluated the Company's strategy of maintaining a REIT portfolio. In September 2006, New Century Management received notice that a potential purchaser was interested in acquiring all of New Century's REIT portfolio assets. By October and November 2006, New Century appeared to favor selling its REIT portfolio over other potential options. At an October 30 and 31, 2006 Board meeting, Morrice discussed the reasons for selling the REIT portfolio and recommended to the Board that New Century formally explore this option.

During the remainder of 2006, New Century discussed with the potential purchaser the possible sale of the REIT portfolio. These negotiations were internally referred to as "Project Kettlebell." A large investment bank assisted New Century with Project Kettlebell and provided revised financial analyses that the investment bank had prepared earlier in the year in connection with Project 2000.

As had been done in connection with the earlier Project 2000 bids, New Century, the potential purchaser of the REIT portfolio and the investment bank advising New Century

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[261] Press Release, *New Century Financial Corporation Announces $50 Million Private Placement of Trust Preferred Securities*, (Sept. 13, 2006) *available at* http://investorrelations.ncen.com/phoenix.zhtml?c=73989&p=iral-thewsarticle_Print&ID=905157&highlight.

[262] Press Release, *New Century Financial Corporation Announces $35 Million Private Placement of Trust Preferred Securities*, (Nov. 17, 2006) *available at* http://investorrelations.ncen.com/phoenix.zhtml?c=73989&p=iral-thewsarticle_Print&ID=932545&highlight.

examined key accounting measures, including discount rates and valuation of residual interests, in connection with Project Kettlebell. The investment bank also discussed challenges that were developing in the subprime mortgage market, such as dramatic industry-wide increases in early payment defaults and lower origination volumes.

On December 12 and 13, 2006, Morrice updated the New Century Board about the status of Project Kettlebell and New Century's discussions with the potential purchaser. Negotiations continued throughout this time, and, in January 2007, the potential purchaser made a bid of $540 million for the Company's REIT portfolio. It appears that there was some support for taking this offer within New Century. Specifically, an executive summary drafted by Senior Management recommended the Company take the offer, and Einhorn said in his interview during the investigation that he would have approved the sale to the potential purchaser no matter what the loss was. However, at an executive session of the independent members of New Century's Board of Directors held on February 1, 2007, "the non-Management directors determined that they would recommend to Management not [to] pursue the potential sale of the REIT portfolio" to the bidder. New Century never accepted the potential purchaser's offer, and it appears no further negotiations took place.

13. Late January and Early February 2007 Board and Audit Committee Meetings

At the Audit Committee and Board of Directors meetings held on January 31 and February 1, 2007, New Century Management informed the Company's Audit Committee and Board of Directors that the Company had been calculating incorrectly its repurchase reserves since the second quarter of 2006. The following excerpt is from the minutes of the Audit Committee meeting on January 31, 2007:

> The next item of business was consideration of the Corporation's accounting practices with respect to repurchase reserves. Mr. Kenneally reported that Management had conducted an initial review of its repurchase methodology with respect to the carrying value of repurchased loans, which had changed in the second quarter of 2006, and had concluded that the Corporation's methodology applied in the second quarter of 2006 was inappropriate. Mr. Zona noted that the Committee had not been informed of this change in methodology and pointed out that he had questioned the Corporation's accounting for its repurchase reserves at a prior Board meeting, and had been assured by Ms. Patti Dodge, the Corporation's Chief Financial Officer at the time, that the accounting for repurchase reserves was appropriate. Mr. Zona then asked whether KPMG had been informed of this change in methodology and Mr. Kenneally responded that KPMG had been informed of the change. Mr. Kim [from KPMG] agreed that

> KPMG and the Corporation had discussed the change in methodology. Next, Mr. Zona asked why the Committee had not been informed of the change in methodology and Mr. Kenneally responded that it was an inadvertent oversight.

The full Board was then informed of and discussed this issue in its meeting on January 31, 2007:

> Next, the Board and Management discussed the repurchase reserve adjustment and the change in the Corporation's methodology for estimating its allowance for loan repurchase losses that occurred in the second quarter of 2006.
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> . . .
>
> Mr. Kenneally then responded to the Board's questions regarding why the Corporation had changed its methodology for estimating its allowance for loan repurchase losses in the second quarter of 2006. Next, the Board expressed its concern that the Audit Committee had not been informed of the change in methodology. Mr. Kenneally then reported that the Corporation was working with KPMG to analyze the impact that the return to the more appropriate accounting methodology and the utilization of the back-log of claims outstanding would have on the Corporation's previous period financial statements. Management informed the Board that if the new information and resulting financial impact resulted in the correction of an error rather than a change in estimate, the Corporation may have to restate its financial statements for one or more periods in 2006.

In interviews, Board and Audit Committee members described Management's revelations at the January 31 meetings as "shocking." They had come to the meeting without any prior understanding that such a disclosure would be made, and they described the discussions at the meeting as being "very emotional" and "ugly." Some stated that they found incredible Kenneally's explanation of Management's failure to inform the Board about the change in repurchase reserve methodology as an "inadvertent oversight."

At a combined telephonic meeting of New Century's Board of Directors and Audit Committee held on February 7, 2007, New Century's Management recommended that the Company delay its fourth quarter and full year 2006 earnings release, and restate its financial results for the first three quarters of 2006, as a result of the previously reported problems with the calculation of repurchase reserves. A presentation prepared for the Board meeting explained that Management had ceased marking repurchased loans to fair market value in the second quarter of 2006, and had ceased including an estimate of the severity of loss on the resale of repurchased loans in the third quarter, in each case because of its interpretation that these factors were already included in the Company's overall LOCOM analysis of loans held for sale.

In response to the Board's questions, Kenneally apparently informed the Board that the use of the inappropriate methodology for calculating repurchase reserves, and the failure to account for the back-log in repurchase claims, had impacted pre-tax net income by approximately $300 million in 2006, including approximately $160 million in the first three quarters and $140 million in the fourth quarter. At that time, members of the Company's Senior Management provided the Board with a draft of a press release to be issued later that day.

Among the related topics discussed at the Board and Audit Committee meeting were whether to disclose in the press release an estimate of the restatement impact and of fourth quarter adjustments to be made to the valuation of residual interests (based on advice from counsel, the Board determined not to disclose such estimates); expectations for shareholder litigation; and the need to work with New Century's warehouse lenders to obtain waivers to various loan covenants. New Century's financing arrangements generally required the Company to deliver timely financial statements to lenders, and many lenders also required that the Company show positive net income for any two consecutive quarters.[263] Morrice stated at the February 7 meeting that he was "very concerned" about loan covenants that were tied to the Company's profitability and that Management would begin "scrambling" to obtain waivers and amendments. Morrice said in his interview during the investigation that the restatement announcement undermined the confidence of New Century's warehouse lenders and created credibility issues for the Company.

14. February 7, 2007 Announcement

On February 7, 2007, following its combined telephonic Board and Audit Committee meeting, New Century announced publicly in a Form 8-K and press release that the Company's financial statements for the first three quarters of 2006 "should be restated to correct errors [New Century] discovered in its application of generally accepted accounting principles regarding [New Century's] allowance for loan repurchase losses."[264] Specifically, New Century announced that, in calculating its allowance for loan repurchase losses, (1) during the second and third quarters of 2006, the Company had failed to account for expected discounts upon the disposition of repurchased loans, and (2), during the first three quarters of 2006, the Company

[263] Form NT 10-K, March 2, 2007.

[264] Form 8-K, Feb. 7, 2007, Item 4.02; Press Release, *New Century Financial Corporation to Restate Financial Statements for Quarters Ended March 31, June 30 and September 30, 2006*, (Feb. 7, 2007) *available at* http://investorrelations.ncen.com/phoenix.zhtml?c=73989&p=iral-thewsarticle_Print&ID=960333&highlight.

did not properly consider the growing volume of repurchase claims outstanding that resulted from the increasing pace of repurchase requests during 2006, compounded by the increasing length of time between whole loan sales and the receipt and processing of repurchase requests.[265] According to the announcement, New Century was reviewing the full impact its restatements, but expected net earnings for each of the first three quarters of 2006 to be "reduced."[266] The Company thus cautioned that its previous interim financial statements for 2006 "should no longer be relied upon."[267]

New Century's February 7, 2007 Form 8-K and press release also announced that the Company expected to record a net loss for the fourth quarter of 2006 as a result of (1) a fair value adjustment made to the Company's residual interests in loan securitizations to reflect revised prepayment, loss, and discount rate assumptions with regard to loans underlying the residual interests, and (2) the continuing high rate of early payment defaults and loan repurchase requests in the fourth quarter.[268]

On February 8, the day after New Century's announcement, the Company's stock price closed at $19.24, down 36% from the February 7 close of $30.16.

15. March 2, 2007 Announcement

On March 2, 2007, New Century announced that it would be unable to timely file its Annual Report on Form 10-K for the year ended December 31, 2006.[269] New Century reported that it expected the previously announced restatement regarding the Company's allowance for loan repurchase losses to result in net income for the first three quarters of 2006 that was "significantly lower" than previously reported.[270] Further, New Century announced that it expected to report a pre-tax loss both for the fourth quarter of 2006 and for the entire year.[271] These negative results were attributed to: (1) declines in net gain on sale of mortgage loans due to increased loan repurchase demands from whole loan buyers, increases in the percentage of loans rejected by whole loan investors, and increasing severity of losses in discounted loan sales;

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[265] *Id.*

[266] *Id.*

[267] *Id.*

[268] *Id.*

[269] Form NT 10-K for 2006.

[270] *Id.*

[271] *Id.*

(2) a reduction in the carrying value of residual assets to reflect revised prepayment, loss, and discount rate assumptions for the underlying loans; (3) a reduction in the carrying value of mortgage loans held for sale, reflecting the Company's revised estimate of the value of these loans based on market conditions; (4) an increase in New Century's allowance for losses on its portfolio of loans held for investment, reflecting recent loss experience, changing market conditions, and updated expectations regarding higher credit losses and faster prepayment speeds; and (5) a reevaluation of the realizability of deferred tax assets.[272]

New Century's March 2 announcement also reported that the Company was seeking waivers and/or amendments from warehouse lenders with respect to loan covenants requiring that (1) New Century timely deliver to the lenders financial statements in compliance with GAAP, and (2) the Company show positive net income for any rolling two-quarter period.[273] According to the announcement, KPMG had informed the Audit Committee that it would provide a "going concern" opinion if New Century were not able to obtain waivers or amendments from a sufficient number of its lenders.[274]

Finally, New Century's March 2 announcement disclosed that the SEC staff had requested a meeting to discuss events leading up to the restatement announcement, and that the United States Attorney's Office for the Central District of California had opened a criminal inquiry relating to the Company's accounting and to trading in New Century's securities.[275]

New Century's March 2 announcement led to another precipitous decline in the Company's stock price. On March 5 (Monday), the next trading day after March 2, New Century's stock closed at $4.56 per share, down from a close of $14.65 on March 2.

16. Critical Liquidity Pressures

New Century's previously undisclosed financial and accounting problems created a crisis for the Company with respect to its warehouse lenders, on which New Century depended for financing. On March 8, 2007, New Century reported that it had received an aggregate of approximately $150 million margin calls from its warehouse lenders, approximately $70 million

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[272] *Id.*

[273] *Id.*

[274] *Id.*

[275] *Id.*

of which the Company had not been able to satisfy.[276] On March 12, 2007, New Century disclosed that many of its warehouse lenders had informed the Company in the week prior that New Century's failure to satisfy margin calls, make certain cash payments and maintain certain levels of profitability, among other things, amounted to events of default under its master repurchase agreements with the lenders.[277] New Century reported further that, due to these alleged defaults, and pursuant to the terms of the various master repurchase agreements, many of its warehouse lenders were accelerating the Company's obligation to repurchase the outstanding mortgage loans financed under the respective agreements with the warehouse lenders.[278] The Company stated that it would not be able to satisfy all of its outstanding repurchase obligations, which totaled $8.4 billion at that time, should all of its warehouse lenders seek to exercise their right to accelerate the Company's repurchase obligations.[279] On March 13, 2007, the NYSE announced that it had filed an application with the SEC to delist New Century's stock.[280]

By the end of March 2007, New Century had received default and acceleration notices from all of its warehouse lenders, several of which had informed the Company that they intended to take the following actions: (1) sell the outstanding mortgage loans financed under the respective master repurchase agreements; (2) offset the proceeds from such sales against New Century's obligations to the warehouse lenders; and (3) reserve all rights to seek further recovery from the Company.[281] As of March 31, 2007, the Company's outstanding repurchase obligations under master repurchase agreements with warehouse lenders exceeded $7 billion.[282]

During this same time period, all of New Century's warehouse lenders ceased providing the Company with financing to continue funding new mortgage loan originations and purchases.[283] Additionally, the Company began receiving cease and desist orders from regulators in various states, pursuant to which New Century was ordered to stop taking mortgage

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[276] Form 8-K, Mar. 8, 2007, Item 8.01; *see also* McCarthy Declaration at 14, para. 50.

[277] Form 8-K, Mar. 12, 2007, Item 2.04.

[278] *Id.*

[279] *Id.*

[280] Form 8-K, Mar. 14, 2007, Item 3.01.

[281] Form 8-K, Mar. 28, 2007, Item 8.01.

[282] McCarthy Declaration at 7, para. 20.

[283] *Id.* at 7, paras. 14, 21, 51; Form 8-K, Mar. 12, 2007, Item 2.04.

loan applications, among other things.[284] Subsequently, New Century ceased its mortgage loan origination operations[285] and entered into an agreement to sell its loan servicing rights and business.[286]

17. Retention of AlixPartners

In mid-March 2007, New Century retained AlixPartners LLP, a global restructuring, consulting and financial advisory firm, to assist in the management of the Company. Personnel from AlixPartners have helped manage New Century's cash flow since March 2007. As of June 8, 2007, Holly Etlin of AlixPartners served as New Century's CEO and Michael Tinsley of Alix Partners served as the Company's CFO.[287]

18. New Century's Bankruptcy Filing

Following unsuccessful attempts to obtain additional financing,[288] the Company filed for bankruptcy in this Court on April 2, 2007.[289] As indicated above, New Century's bankruptcy filing was the largest such filing in 2007 measured by pre-petition assets. As of the date of this Final Report, New Century's bankruptcy filing ranks as the ninth largest of all time, measured by pre-petition assets.[290]

New Century's stock has consistently traded below $1 since mid-April 2007, and below $.20 since early-August 2007.

19. The Internal Investigation by the Company's Audit Committee

As a result of the announced need to restate the Company's interim financial statements for 2006, the Audit Committee of New Century's Board of Directors commenced an internal investigation into the Company's accounting for loan repurchase losses. The investigation was subsequently overseen by the SIC and was expanded to include New Century's valuation of

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[284] McCarthy Declaration at 16, paras. 57-58.

[285] Form 8-K, Mar. 8, 2007, Item 8.01; McCarthy Declaration at 14, para. 51.

[286] Form 8-K, July 5, 2007, Item 2.01.

[287] Form 8-K, June 12, 2007.

[288] Form 8-K, Mar. 8, 2007, Item 8.01 (noting that "the Company is in discussions with lenders and other third parties regarding a refinancing and other alternatives to obtain additional liquidity.").

[289] Form 8-K, Apr. 2, 2007, Item 1.03.

[290] Press Release, *Number of Public Bankruptcies Slightly up in 2007, Fifth Lowest Ever, According to BankruptcyData.com*, (Jan. 16, 2007) *available at* http://www.businesswire.com/portal/site/home/index.jsp?epi_menuItemID=887566059a3aedb6efaaa9e27a808a0c&ndmViewId=news_view&ndmConfigId=1008918&newsId=20080116006169&newsLang=en.

residual interests in 2006 and prior periods. The special investigation was performed by Heller which engaged PwC to assist in the internal investigation.

Based on the information and documents Heller and PwC provided to the Examiner, the SIC did not produce a written report containing its findings or conclusions. However, the Examiner was provided with file memoranda created by Heller that describe interviews conducted with various New Century personnel from March through June 2007, along with a written summary of the process of the SIC's investigation. The undated 21-page written summary describes the process of the internal investigation conducted by Heller and PwC for the SIC, including background information and information about document preservation, collection, searching and review.

Representatives of Heller and PwC met on two occasions with the Examiner and his counsel, in June and July 2007. In those meetings Heller and PwC described generally the work they performed for the SIC and provided a PowerPoint Presentation.

20. The May 24, 2007 Announcement

In connection with the internal investigation for the SIC, on May 24, 2007 New Century reported the following:[291]

> [T]he Audit Committee has determined that there were errors in the Company's previously filed annual financial statements for its fiscal year ended December 31, 2005 (the "2005 Financial Statements") with respect to both the accounting and reporting of loan repurchase losses and the Company's valuation of certain residual interests in securitizations. . . . [T]he Audit Committee and Management believe that it is more likely than not that these errors in the aggregate resulted in a material overstatement of pretax earnings in the 2005 Financial Statements. Accordingly, on May 23, 2007, the Company's Board of Directors concluded, based upon the recommendation of the Audit Committee, that the 2005 Financial Statements should no longer be relied upon.

The Company also reported, "[A]s the Company is currently in liquidation proceedings under Chapter 11 of the Bankruptcy Code, the Company does not expect to complete a restatement of either the 2005 Financial Statements or the Interim Financial Statements [for the first three quarters of 2006]."[292]

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[291] Form 8-K, May 24, 2007.

[292] *Id.*

V. LOAN QUALITY

A. Introduction and Summary

New Century originated ever-increasing quantities of subprime residential mortgage loans. New Century's financial success depended ultimately on the quality of its origination of inherently risky subprime mortgage loans. Poor quality control in the origination of such loans could imperil New Century's financial success in multiple ways: loans might be rejected by purchasers or might bring lower prices; loans sold to investors on which there were early defaults might result in a requirement that New Century repurchase the loan; and loans kept on New Century's balance sheet could result in lost interest income and lower valuations if borrowers had high delinquency rates. In addition, the quality of New Century's loan originations had a significant impact on the various assumptions relied upon in preparing New Century's financial statements. For these and other reasons, it was in New Century's interest to have monitored loan quality carefully and to have prioritized resolving any serious loan quality problems that arose.

The term "loan quality" as used in this Final Report refers to the New Century's loan origination processes, which were supposed to ensure that New Century loans met its own internal underwriting guidelines, as well as the requirements of the investors that purchased New Century loans. Such loan origination processes required that New Century properly qualify individual borrowers for the particular loan products, including the increasingly risky subprime loan products that New Century originated from 2004 through early 2007.

The Examiner's investigation focused on whether New Century's Senior Management and its Board of Directors devoted timely and sufficient attention to loan quality, particularly when certain red flags appeared. Those red flags included:

- An increase in EPD by borrowers, beginning in 2004, which suggested that New Century was making loans to borrowers who had not been properly qualified for the particular loan products;
- An increase in investor rejections of loans that New Century sought to sell (so-called "kickouts" or "fallouts"), beginning in 2003 and 2004. The chief reasons for the investor kickouts included defective appraisals, incorrect credit reports and missing documentation, which suggested that New Century's loan origination processes were not consistently producing loans that met New Century's underwriting standards and investor guidelines. Kickouts were particularly problematic because New Century either attempted to find other purchasers, often at lower prices, for the kicked out loans, or placed them in the Company's own portfolio. All loans that were not sold promptly after funding negatively impacted the Company's liquidity;

- Identification by New Century's Quality Assurance and Internal Audit Departments beginning in 2003 of significant flaws in New Century's loan origination processes, which often mirrored the reasons that investors were refusing to purchase increasing percentages of New Century loans;
- An increase in loan repurchase claims from whole loan purchasers, beginning in the second quarter of 2005;
- A rise in interest rates, beginning in June 2004, which affected the ability of credit-challenged borrowers to meet loan payment requirements, particularly on ARM, and increased default risks;
- A slowing, and even the end, of house price appreciation in certain regions of the country in 2006, which limited the ability of borrowers to refinance loans when they could not meet payment obligations on their existing loans, again increasing default risks;
- New Century's increasing origination, from 2004 onward, of increasingly risky products, such as Stated Income loans (where the borrower did not need to establish via documentation that he/she had sufficient income to be able to repay the loan) and 80/20 loans (where the loan represented 100 percent of the property value, consisting of an 80% first lien and a 20% second lien), with such higher risk features often combined together in a single loan through a so-called layering of risks ("layered risks");
- An increasingly competitive subprime market, beginning in 2004, typified by shrinking margins between the interest rates New Century could charge on loans it was originating and the interest rates New Century was charged by lenders on the funds New Century borrowed to finance its loan originations; and
- A decrease beginning in 2004 in the premium prices that New Century received for the loans it sold.

The Examiner concludes that New Century's Senior Management and Board did not devote sufficient attention to loan quality problems, even after these red flags were identified. Indeed, New Century devoted little attention to improving loan quality until 2006 and did not focus specific attention until the final quarter of 2006, which was too late to prevent the consequences of longstanding loan quality problems in an adversely changing market.

New Century's Senior Management recognized that the Company had serious loan quality issues beginning as early as 2004. For example, in April 2004, New Century's Chief Credit Officer reported that "the QA results [pertaining to the loan origination processes] are still at unacceptable levels" and that "Investor Rejects [kickouts] are at an incline as well." Two months later, in June 2004, the head of Secondary Marketing remarked in an e-mail that "we have so many issues pertaining to quality and process!" Later, in September 2004, it was

reported that investors had rejected 7.17% of loans that New Century had sought to sell in July 2004, which was more than two percentage points higher than the five percent rate that was viewed as the highest acceptable kickout rate. Finally, from approximately June 2004 through the rest of the year, there was a sharp rise in EPD. For all of 2004, the failure of borrowers to make the first, second or third payments on newly originated loans, stood at 7.24% and constituted $1.82 billion of loans, an EPD rate that was 2.86% higher than the 2003 rate.

The Examiner finds that these 2004 developments, taken as a whole, should have prompted Senior Management to develop an action plan to address these troubling loan quality trends. However, despite some discussions, no member of Senior Management was directed to be responsible and accountable for improving loan quality. Rather, New Century continued to focus on generating greater quantities of ever riskier loans, devoting little effort to such basic issues as making sure that the Company's loan origination and underwriting policies and procedures were followed to avoid kickouts of loans offered for sale. Such lack of attention to quality had a stark result. For example, investors kicked out $1.035 billion of New Century loans in the last six months of 2004 alone.

The situation in 2005 was little different from 2004, although the trend data pointed even more clearly to serious loan quality problems. Some of the 2005 trends were striking. For instance:

- Kickout rates in 2005 exceeded New Century's five percent acceptable limit in 10 of 12 months, with the same sorts of deficiencies being cited month after month; investor kickouts for all of 2005 totaled $2.281 billion;
- EPD increased throughout the year, going from 6.86% of loans originated in the first quarter of 2005 to 9.68% of loans in the fourth quarter, with the overall 2005 average at 8.30% compared to 7.24% in 2004 and 4.38% in 2003;
- New Century's Secondary Marketing Department reported in September 2005 that the Company's 80/20 loans from 2004 had a four-times higher 60+ day default rate than other New Century products, presenting serious risk issues, especially since 80/20 loans amounted to more than 33% of New Century's loan production by September 2005; and
- The Internal Audit Department conducted nine field audits of New Century's loan origination processes in 2005, resulting in seven "Unsatisfactory" and two "Needs Improvement" ratings, as well as identification of numerous problems that suggested serious loan quality deficiencies.

The response of Senior Management and the Board to these 2005 trends was similar to their response in 2004: loan quality was a frequent topic of discussion but no effective remedial

actions were implemented. Indeed, at an October 25, 2005 Audit Committee meeting, there was a relatively full discussion of loan quality issues, including an observation by the Audit Committee Chairman that "the percentage of loans originated by the Corporation that contained defects had traditionally been too high." Despite these discussions, however, loan quality was not a priority. Just as in 2004, no one was directed to be responsible and accountable for any loan quality improvement effort.

The loan quality trends in 2006 continued to be negative, with kickout rates above the five percent acceptable level every month and reaching 14.95% by year-end, and with the same sorts of issues, such as defective appraisals and missing documentation, identified month after month as the primary reasons for kickouts. The value of the kicked out loans in 2006 was $4.622 billion. Similarly, EPD continued to trend upward month after month, exceeding 10% in every month after March 2006 and reaching 16.82% in December 2006. In the face of such trends, and the negative Internal Audit field audit results, the Audit Committee at its January 2006 meeting focused on the need for Senior Management to improve loan quality. Indeed, the Audit Committee directed Senior Management to report back to the Committee in March 2006 on efforts to improve operations, quality control and quality assurance in the Company's loan origination and processing centers.

Eventually, New Century took certain concrete steps to improve loan quality in 2006, including the following:

- Development of a new Loan Quality Scorecard that permitted Senior Management to identify loan quality problems and who in the loan origination process may have made errors, such as approving a deficient appraisal;
- Development of an improved Quality Assurance ("QA") Department;
- Introduction of a new anti-fraud program that prevented the funding of hundreds of millions of dollars of questionable loans;
- Introduction of an Operational Risk Audit Program that conducted reviews of the loan origination process prior to the funding of loans;
- The strengthening of certain underwriting guidelines, with the objective of curtailing EPD and repurchase claims; and
- Designation of the heads of the Production and Operations Departments as having "ownership" of the Loan Quality Improvement Program.

Loan quality improvement still never became a top priority for New Century in 2006, however, and most of the improvements noted above were not implemented until late in the year.

While diligent efforts appear to have been undertaken on discrete items, there is no apparent sense of urgency to make sure that improvements were implemented as quickly as possible. In one area – loan kickouts – the Examiner concludes that no effective action was taken at all. Month after month, the same sorts of problems, such as defective appraisals and missing documentation, were cited as among the chief reasons that investors increasingly kicked loans out of pools being sold by New Century. New Century's head of Production, Anthony Meola, expressed his frustration in January 2007, commenting that New Century's appraisal processes were "stale, [and that] we need to address them next expeditiously" and in another e-mail stated "we have been asking for 5 months, when can we attack appraisals and how?"

The Examiner sought to determine why Senior Management failed to dedicate resources to improve loan quality during 2004, 2005 and for much of 2006. The Examiner believes that a number of factors contributed to New Century's failure to address such a critical issue. First, New Century's loan originations grew at an enormous rate from 2000 through 2006, becoming the second largest subprime lender by the end of 2004 and remaining one of the largest in 2005. The Production Department was highly motivated and effective in originating such loans and apparently resisted changes that might have limited loan production volume. While both the Quality Assurance and Internal Audit Departments identified loan quality problems, and kickout and EPD rates confirmed many of these problems, the Production Department devoted its resources to generating high volumes of loans, with relatively little attention to loan quality. Indeed, in September 2005, soon after receiving an "Unsatisfactory" Internal Audit report, Patrick Flanagan, the former head of Production, advised Internal Audit and others that Production's success over the years in generating revenues made the Internal Audit results essentially irrelevant:

> If recollection is correct, every singe [sic] audit completed has been unsatisfactory which to me sounds like we need to ammend [sic] policy as much as clean up our act. The financial results that have been ackomplished [sic] over the past few years are inconsistent with the audit results.

In addition, Production resisted suggested changes in the Production compensation system that would have linked improved loan quality to compensation. Compensation within the Production Department, including significant bonuses, historically focused on loan origination volume. Senior Management recognized that Production compensation needed to be tied to loan quality if there was to be meaningful improvement in the quality of the loans originated by New

Century. For example, in a September 2004 memorandum, Brad Morrice, then Chief Operating Officer, observed:

> Regardless of the inclusion or exclusion of QA's results [as a metric for judging loan quality], I believe that whatever measurements we agree upon should be tied to production compensation otherwise this has no teeth and continues to be an exercise in futility. (emphasis supplied)

The Examiner found little evidence that Production compensation ever was tied to loan quality results. Indeed, as late as November 2006, Internal Audit reported that commission payments made to account executives and area sales managers were not affected by EPD, kickouts and repurchases.

New Century measured loan quality primarily in terms of whether it was successful in selling loans to investors. So long as investors continued to be willing to purchase New Century loans, New Century apparently did not believe it needed significantly to improve loan quality, even as the prices investors paid for loans declined in 2004 and 2005. In 2006, when New Century finally focused more on loan quality issues, it was partly in response to the demands being made by investors for better quality loans, particularly prompted by a large increase in investor repurchase claims. One former senior executive informed the Examiner that he wished that New Century had addressed the trends earlier so that the Company could have implemented loan quality enhancements earlier, stating that Senior Management simply did not focus on the seriousness of the trends before approximately September 2006.

New Century also appears to have paid little attention to improving loan quality prior to the fall of 2006 because certain comparative data suggested that New Century loans, on average, were performing better than those of its competitors. Senior Management received a wake up call in September 2006, when data showed that New Century loans originated in early-2006 had much worse delinquency rates than comparable loans originated by other subprime lenders. Further, Senior Management appeared to believe that regardless of day-to-day market conditions and ever more discerning and discriminating investors, New Century would survive, just as it had survived the downturn of 1998-2001. In addition, the increasingly alarming trends in 2006 in EPD, repurchase claims and kickouts appear to have received less attention because New Century viewed these as industry-wide problems and not problems unique to New Century.

The Examiner finds that the foregoing reasons do not satisfactorily explain New Century's failure to make improving loan quality a priority at a much earlier date. Neither

comparative data nor its prior survival during an earlier market downturn changed the fact that New Century faced increasing numbers of EPD, kickouts and repurchase claims, as well as reduced margins, which should have put the Company on alert that improving loan quality was critical to its long-term financial success. Further, New Century's own internal data showed that many of the loans it originated in 2005 had much higher delinquency rates than loans originated by New Century in 2003 and 2004. New Century Management attributed the higher delinquency rates mostly to New Century's increasing risk profile. For example, Senior Management identified Stated Income loans to single borrowers in an 80/20 product as performing much worse in 2005 compared to 2003 and 2004, stating "[w]e again see the horrendous performance of the Stated Income/Single/80/20 loans." Nonetheless, little was done to curb such risks until late 2006.

The Examiner recognizes, as noted previously, that New Century was engaged in the subprime industry, which necessarily carried with it higher risks than other forms of mortgage lending. New Century, however, not only did not properly address these risks, but continued to be an aggressive originator of ever-increasing volumes of high risk mortgage loans, with relatively little attention to meaningful efforts to improve loan quality. New Century's Board and Senior Management may be criticized for their failures to identify loan quality as an item that needed far earlier and more focused attention and effort.

The Examiner believes that Senior Management in particular deserves criticism for failure to devote efforts to the alarming loan kickout rate. As noted, the same sorts of problems were identified month after month as resulting in kickouts. Some of the problems may have been more difficult to solve, such as some of the appraisal issues that involved subjective judgments. Other issues, however, were termed by New Century personnel as "no brainers" and "black and white" issues – issues that should not have been missed month after month and were viewed even within New Century as relatively easy to fix. The Examiner identified no evidence of any decision to the effect that the costs associated with addressing kickouts were too great to justify the effort. To the contrary, virtually every monthly kickout report from mid-2004 onward stressed the need to get the kickout rates lower, but there was simply no meaningful action. This inaction may have cost New Century millions, if not hundreds of millions of dollars. For example, in 2006, investors rejected an estimated $693 million in loans because the loan files lacked required documents.

The Examiner cannot conclude that, if New Century had focused on loan quality far earlier, it would have avoided bankruptcy. Indeed, many persons interviewed by the Examiner expressed the view that, even without its accounting problems, New Century, like so many others in the subprime market, was doomed to failure unless it found a partner to provide a major cash infusion. The Examiner cannot express an informed view whether such speculation is well-founded. The Examiner can conclude, however, that if New Century had focused on loan quality in a more timely, energetic and effective manner, it would have improved its liquidity (via reduced EPD and repurchase claims and fewer kickouts) and may have been able to continue its operations longer and may have survived long enough and had a sufficient quality of assets and operations to attract an investor before the rest of the subprime market collapsed.

B. The Loan Quality Investigation

The Examiner investigated to determine how New Century went about originating loans, the means by which it sought to monitor the quality of the loans it originated, and the steps it took to improve loan quality when it knew that loan quality issues were presented. In carrying out this investigation, the Examiner sought to view data in the context of the 2004 through early-2007 time period and to avoid using hindsight to judge the actions of New Century's Board and Management.

New Century operated a huge and complex loan origination process, funding more than $200 million in loans every business day in most months from April 2005 through December 2006. The Examiner did not attempt to investigate each aspect of that process, such as to judge the appropriateness of the particular underwriting guidelines that might have been in effect at a particular time or whether individual changes to such guidelines were made with appropriate care. Such an undertaking was beyond the scope of the June 1 Order.

The New Century loan origination process can be briefly summarized as follows:

> The vast majority of New Century loans were originated through New Century's wholesale processing centers. By late 2005, New Century had established relationships with almost 50,000 mortgage brokers, who would submit loan applications to New Century through New Century's network of almost 1,000 account executives or through New Century's web-based loan underwriting process called FastQual. New Century also purchased funded loans from mortgage bankers and financial institutions that acted as correspondent lenders.
>
> In 2005, New Century's retail platform originated about 12.3% of all loans, compared to 87.3% originated by the wholesale platform. The retail origination process generally was similar to the wholesale process, except that retail

personnel dealt with prospective borrowers directly, instead of dealing through independent brokers and correspondent lenders.

Once a loan application was received, the application would be reviewed by underwriters and sometimes risk managers to determine whether it was complete and met underwriting conditions and other guidelines. Loans from correspondent lenders similarly went through a re-underwriting process. The underwriting process included "an evaluation of credit history and income, the appraisal, preliminary title report, and other loan package documents to determine whether the loan request should be approved, declined or conditionally approved."

In some instances, applications did not meet all underwriting guidelines and other conditions. Some such applications would be rejected. In other instances, the application might be approved through the grant of exceptions. The most common exceptions were maximum loan amount limits, loan to collateral value limits and debt to income limits. Different persons in the Production Department had different levels of exception authority. There does not appear to have been a clear exceptions policy. Indeed, Morrice commented in a September 2004 memorandum that New Century's exceptions policy was "unclear" and Kevin Cloyd in response stated "Our exceptions policy – do we have one?" However, it was acknowledged that exceptions could be granted in a variety of circumstances. For example, the Form 10-K for 2004 provided:

> On a case-by-case basis, we may determine that an applicant warrants an LTV exception, a debt service-to-income ratio exception, or another exception to our underwriting criteria. We may allow such an exception if the application reflects certain compensating factors including low LTV, a maximum of one 30-day late payment on all mortgage loans during the last 12 months, and stable employment or ownership of the current residence. We may also allow an exception if the applicant places in escrow a down payment of at least 20% of the purchase price of the mortgage property or if the new loan reduces the applicant's aggregate mortgage payment. Our automated credit grading system aids in identifying and managing underwriting exceptions. Certain of our loan programs and risk grade classifications limit the approval of exceptions to higher loan approval authority levels.[293]

Once an application was approved, with or without exceptions, the loan would be funded, with most loans funded within 30 days of receipt of the application.

The Examiner cites in this portion of the Final Report data that primarily were generated by New Century, such as data on EPD, kickouts, the grant of underwriting exceptions and the identification by New Century of particular mortgage products that had greater or lesser risks. Based upon witness interviews and other evidence, the Examiner believes such data generally are accurate. However, the Examiner was not able to verify independently the data, and in some

[293] Form 10-K for 2004 at 13.

instances, the available data were not reported on a consistent basis and were incomplete. For example, with regard to underwriting exceptions, New Century data revealed the following:

> In its Forms 10-K for 2002 and 2003, New Century reported that underwriting exceptions, as a percentage of the dollar amount of originations, amounted to 18.5% and 14.9% of originations in those years respectively.[294]
>
> In its Form 10-K for 2004, New Century changed its method of exception reporting, by reporting only the percentage of loans that had exceptions and eliminating the dollar amount analysis: "For the years ended December 31, 2004, 2003 and 2002, our overall underwriting exception rates were 7.4%, 8.4% and 13.5%, respectively."[295]
>
> In the Form 10-K for 2005, New Century did not report on exception rates at all and available data indicate that between June 2005 and October 2006, New Century did not have accurate exception data.

Such inconsistent data reporting made it difficult for the Examiner to analyze just how frequently exceptions were made to underwriting guidelines. The available data suggest, however, that exceptions were frequent and amounted to at least 10% of loan amounts by dollar value of originations during 2004 through 2007.

C. Loan Quality Should Have Been Extremely Important to New Century in 2004 through 2007

Loan quality should have been extremely important to New Century for at least two reasons. First, the vast majority of New Century's revenues derived from the inherently riskier subprime loans that it originated. Second, loan quality was all the more important from 2004 onward because certain factors, such as rising interest rates, the leveling of housing prices, compressed margins in the loan origination and sale business, and the increasing riskiness of New Century's loan products, all pointed to a more difficult and higher risk operating environment for New Century. In that environment, New Century should have known that good execution and quality in its origination of subprime mortgage loans were important to ensure New Century's success.

1. New Century's Loans Were Key to New Century's Revenues

New Century's two greatest sources of revenues were subprime mortgage loan sales and interest earned on subprime loans prior to sale and on loans held for investment on New Century's balance sheet.

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[294] Form 10-K for 2003 at 11.

[295] Form 10-K for 2004 at 13.

a. Loan Sales

Historically, New Century sought to sell virtually 100% of the loans that it originated, either in whole loan sales or in securitizations accounted for as sales. Beginning in 2003, New Century started to hold some of its loans for investment on its balance sheet. From 2003 through 2005, New Century sold between 75 and 80% of its originations, holding the rest of the loans on its balance sheet through securitizations accounted for as financings. In the first nine months of 2006, New Century loan sales amounted to approximately 92.5% of 2006 originations.

In 2003 and after, most sales were structured as whole loan sales, as opposed to securitizations accounted for as sales.[296] In general, a pool of loans would be created and the investor then would have an opportunity to conduct due diligence on the loans in the pool, typically reviewing approximately 25% of the loans offered for sale, with a further review often conducted on a greater percentage of the appraisals. The investor would advise New Century which loans it did not want to purchase – the kickouts – and would typically tell New Century its reasons for rejecting the loans, such as unacceptable deviations from underwriting guidelines, defective appraisals and missing documentation. New Century personnel then would seek to reduce the proposed kickout rate, either by convincing the investor that it was wrong in rejecting certain loans or by fixing some defect that affected a particular loan. Once the precise pool was finalized, New Century and the investor would agree to a price. As discussed below, kickout rates were tracked by New Century as an important loan quality metric.

New Century typically sold its loans at a premium to par value and kept track of its so-called "net execution," which represented "the premium paid to [New Century] by third-party investors in whole loan sale transactions and the net gain recorded for a securitization accounted for as a sale."[297] New Century's net executions showed a significant decline over the years, which reflected the increasingly competitive subprime market:

2003	4.18%
2004	3.58%
2005	2.06%
Q1-Q3 2006	1.59%

[296] Between 2003 and the bankruptcy filing in 2007, all loan sales were in the form of sales to whole loan purchasers except for four securitizations accounted for as sales in 2005, totaling $6.4 billion.

[297] Form 10-K for 2005 at 71.

Indeed, in mid-2005, Kevin Cloyd, the head of Secondary Marketing, advised Senior Management that New Century's margin in sale transactions had become "RAZOR thin." (emphasis in original).

New Century recorded gains from the sales of its loans. In 2005, New Century reported $622.2 million in gains on loan sales, a 22.2% decrease from the $800.6 million in gain on sale recorded in 2004. The main identified reason for this reduction was the reduced net execution rate. In its Form 10-K for 2005, New Century stated:

> The decrease in gain on sale of loans was primarily the result of a reduction in net execution from 3.58% for the year ended December 31, 2004 to 2.06% for the same period in 2005. The reduction in our net execution was due mainly to changes in and competitive pressures in the secondary market, as well as the interest rate environment.[298]

In the sale process, New Century faced two initial risks: that investors would refuse to buy certain loans; and that investors would pay less for the loans that they were willing to purchase. As noted, investors primarily kicked out loans due to defects in the loan origination processes, such as defective appraisals, unacceptable exceptions made to underwriting guidelines and missing documentation, each of which was an indication of the quality of the loans that were originated, since most loans rejected by purchasers reflected deviations by New Century from its loan origination processes. Similarly, the higher the quality of the loan being presented for sale, the higher the price that investors were willing to pay. [299]

If an investor kicked out particular loans, New Century had several options. First, it could add the loans to another sale pool and seek to sell them, either before or after trying to correct the problem that caused the initial kickout. Second, if the defects were significant, New Century could attempt to sell the loans in a discounted loan sale, i.e., at a price less than the face amount of the loan. In either event, the process was costly in terms of resources that needed to be devoted and could lead to outright losses when loans had to be disposed of at less than par. The kickout process also increased certain risks faced by New Century. As discussed

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[298] Form 10-K for 2005 at 71.

[299] Some loans were rejected by investors for reasons unrelated to deviations in New Century's loan origination processes. For example, some investors would reject certain types of loans, such as Stated Income loans to borrowers with relatively low FICO scores, because those investors simply did not have an interest in purchasing such high risk loans. The Examiner cannot quantify the magnitude of such kickouts but believes that the large majority of kickouts involved loans where an investor identified some deviation from New Century's loan origination processes, which processes, in turn, were designed to mirror the requirements of investors.

immediately below, one risk faced by New Century involved required repurchases of loans if borrowers defaulted on early loan payments. New Century sought to sell loans as soon after funding as possible because New Century learned over the years that borrowers' likelihood of defaults increased as more time passed after initial funding. Accordingly, when loans were kicked out, risks were increased because even if they eventually were sold, even at a premium, the risk that the borrower would default would increase because of the passage of time since loan funding.

New Century faced a third risk in the sale process: repurchases. It was typical in a whole loan sale agreement for New Century to agree to repurchase a loan in either of two circumstances. First, if the borrower defaulted on the first one or two loan payments after a loan was sold, New Century could be required to repurchase the loan or to substitute a new loan acceptable to the investor. This repurchase liability was explained as follows by a New Century employee in a February 24, 2005 e-mail:

> Our purchase liability for first payment defaults include[s] loans that fail to make their first payment to the investor so, even though the borrower may be failing to make their second or third payment overall, we would still be on the hook to repurchase the loan if that payment was the first payment due to the investor. (emphasis in original)

This was the primary reason that New Century was required to repurchase loans, with approximately 90% of repurchases caused by first payment defaults ("FPD"). Second, even after that early default period, a purchaser could require New Century to repurchase a loan if it were shown that certain representations and warranties in the loan purchase agreement, such as representations about the value of the underlying property, proved to be false. This category of repurchase requests grew over time, particularly in 2006, as investors became increasingly inclined to demand repurchases. Poor loan quality, whether because the borrower defaulted on early loan payments or because the loan documentation was deficient, was at issue on repurchases. Such repurchases could have a significant impact on New Century's results. When New Century was required to repurchase a loan, it needed to pay the investor the full remaining principal amount of the loan as well as reimburse the investor for interest not received and for the amount of the premium (or some portion of it) initially paid by the investor for the loan. New Century then might be left holding a loan that could only be sold at a discount, further contributing to a loss.

b. Interest Income

New Century derived extensive revenues from interest earned on the loans that it originated. Such interest income was derived in two ways. First, between the time a loan was funded and the time that a loan was sold, typically 30 to 50 days, the borrower made regular payments of interest and sometimes of principal, which New Century would collect. Second, when New Century held loans for investment on its balance sheet, New Century would record interest received from such loans as part of its income statement.

The interest received by New Century on loans held for sale and loans held for investment became the biggest single revenue item on New Century's income statement in 2004 through 2006. In the 2004 through 2006 time period, such interest income was reported as follows:

2004	$898,647,000[300]
2005	$1,759,567,000[301]
9/30/06	$1,454,733,000[302]

Interest income was directly impacted by loan quality. If loan quality was poor, meaning underwriting standards and guidelines were not being complied with, then default rates on New Century loans would increase and interest collections would be reduced. This was all the more the case since New Century between 2003 and the end of 2006 greatly increased the quantity of loans that it held for investment on its balance sheet, with the balances at reporting periods as follows:

12/31/02	$0
12/31/03	$4.74 billion[303]
12/31/04	$13.2 billion[304]
12/31/05	$16.1 billion[305]
9/30/06	$14.0 billion[306]

[300] Form 10-K for 2004 at 66.

[301] Form 10-K for 2005 at 53.

[302] Form 10-Q for Q3 2006 at 22.

[303] Form 10-K for 2003 at 41.

[304] Form 10-K for 2004 at 70.

[305] At June 30, 2005, the loans held for investment portfolio stood at $18.5 billion. Form 10-Q for Q2 2005 at 35.

[306] Form 10-Q for Q3 2006 at 1.

Such a large increase in loans held for investment, with the inherent embedded credit risk in such loans, was an additional reason that New Century should have had an intense interest in making sure that it originated quality loans.

2. Additional Factors Should Have Caused New Century to Focus on Loan Quality

A variety of additional factors, some outside of New Century's immediate control, should have caused New Century to focus on loan quality.

a. Rising Interest Rates and Leveling Property Values

In the several years preceding 2004, the U.S. economy experienced declining interest rates along with rapidly increasing home value appreciation. These developments helped to stimulate substantial increases in subprime mortgage loan origination volumes for New Century and other lenders.

The situation began to change in June 2004, when the Federal Reserve started to raise interest rates regularly. The prime rate, which had remained flat at four percent for more than a year, increased to 4.25% in July 2004, was at 5.25% by mid-December 2004, and climbed steadily in 2005 and 2006, reaching 8.25% in June 2006.[307] As the prime rate and Federal Funds rate rose, other interest rates rose as well, including those for most residential mortgage loans, and borrowers with ARM were all the more likely to face significantly higher payments when their rates reset. New Century was well aware of the fact that interest rates were almost sure to increase. For example, in January 2005, in a presentation to Senior Management entitled "The View of the World," a Secondary Marketing employee commented:

> It goes without saying that rates will be going up in the next year. Estimates of the Fed Funds rate are in the 3.25% range -- up from 2.25% now and 1.25% in June 2004.

This individual then stated later in the presentation:

> The potential for trouble appears to manifest itself in 2006 (and beyond) with the hybrid loans (especially IO's) [Interest Only] resetting during that year. We can assume that the rising rates we are currently experiencing will continue, resulting in the full initial cap (1.5%) being realized with the associated higher payments.

The rise in interest rates, over time, made it more difficult for borrowers to meet their payment obligations, particularly since most New Century borrowers held adjustable rate

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[307] *Bank Prime Rate Changes: Historical Dates of Changes and Rates*, Fed. Reserve System, Nov. 2, 2007, *available at* http://research/stloudfed.org/fred2/data/PRIME.txt.

mortgages, whose rates would adjust upward as interest rates increased. Significantly, ARM made up 70.1, 73.7 and 73.3% of New Century originations in years 2003, 2004 and 2005 respectively.[308]

At the same time that interest rates were rising, property value appreciation began to slow and, in some regions, by 2006, values actually began to decline. The slowing of property appreciation had a potentially serious effect on borrowers, something that New Century clearly recognized. In the same View of the World presentation, the author noted that "lower housing price increases could hinder the ability of customers to refinance out of loans that are heading for trouble." In prior years, as property values increased, borrowers often could refinance their loans when ARM adjusted to higher interest rates. However, as property prices leveled, many borrowers discovered that they could no longer refinance and thus were facing higher monthly payments without a refinance option.

New Century publicly acknowledged these trends as they occurred. For example, at an investor and analyst meeting in February 2005, Flanagan highlighted the "expected environmental conditions" as follows:

> Rising interest rates – 25 bps [basis points] per quarter
> Moderating, but stable home prices
> Competitive landscape

The rise in interest rates also directly affected New Century. New Century borrowed money to fund loan originations. New Century tracked the difference between the rates that it needed to pay to borrow money and the rates that it could charge borrowers on the loans that it originated. Over the years, this difference or margin narrowed sharply, as short-term interest rates that New Century needed to pay rose faster than the longer-term rates that it could charge to borrowers:

[308] Form 10-K for 2005 at 54.

YEAR	MARGIN
2003	>5%[309]
2004	4.5%
2005	2.7%[310]
1Q, 2Q, 3Q 2006	2.3%[311]

In short, it was clear beginning in 2004, that New Century was facing an increasingly difficult operating environment. In June 2004, the head of New Century's Secondary Marketing Department commented that New Century was "entering a point in time where the wind is racing in our face instead of at our backs" and that during this time "it is more vital than ever to maintain our loan quality, loan performance and positive reputation." Similarly, the minutes from the February 2, 2005 meeting of the Board of Directors refer to the "increasingly competitive environment" faced by New Century. This changing and increasingly difficult operating environment should have been an impetus to New Century to focus on loan origination quality controls and assurances.

b. The Increasing Risk Profile of New Century Loan Products

New Century also should have focused more carefully on loan quality as New Century began to underwrite more mortgage loan products that had greater inherent risks. New Century, as a leading subprime lender, was by definition engaged in a risky business. However, over time, the risks associated with New Century's subprime mortgage loan products increased substantially.

For example, in 2003, 2004, and 2005, New Century greatly increased its origination of IO loan products, where borrowers would make only interest payments for the first several years of the loan, after which amortization of principal was added to the monthly payments. New Century's IO originations as a percentage of total originations for particular months in the mid-2000s were as follows:

[309] Form 10-K for 2004 at 70.

[310] Form 10-K for 2005 at 57.

[311] Form 10-Q for Q3 2006 at 41.

Month	% IO
3/03	0%
12/03	2.77%
6/04	21.39%
12/04	21.04%
6/05	38.49%

IO products were understood to have a higher risk than fully-amortizing mortgage loans, as noted by New Century in its Form 10-K for 2005:

> [U]pon expiration of the interest-only payment, the borrower's payment will increase to cover the fully amortizing payment. The adjustment to the higher payment amount increases the risk that the borrower will default or prepay the mortgage loan. Because no principal payments may be made on such loans for an extended period following origination, if the borrower defaults, the unpaid principal balance of the related mortgage will be greater than otherwise would be the case, increasing the risk of loss in that situation. For those reasons, among others, these interest-only mortgage loans may be less valuable in the secondary market and may result in lesser proceeds to us when sold or securitized as compared to fully amortizing mortgage loans.[312]

The risks associated with the IO products were exacerbated by the fact that New Century generally qualified its borrowers only based on their ability to pay the initial interest on the loan and not on their ability to pay interest plus principal amortization. New Century stated in its Form 10-K for 2005: "For our interest-only adjustable rate mortgage, or ARM, loans we generally use the initial interest-only payment for determining the borrower's repayment ability."[313] As discussed hereafter, New Century finally became concerned about the increasing concentration in IO products, due in part to investors' reluctance to purchase IO products at premium prices, and in September 2005, initiated actions to keep IO originations below 25% of originations thereafter. These actions accomplished their intended purposes and IO originations dropped sharply after the peak at June 2005.

A similar trend toward higher risk products took place in so-called Stated Income loans, where the borrower was not required to provide documentation (such as W-2 forms for the prior year's earnings) establishing that his/her income was sufficient to qualify for the loan in question. In such loans, the prospective borrower would "state" his/her income in the application and New Century would accept such a representation, in many instances with little or no

[312] Form 10-K for 2005 at 35-36.

[313] Form 10-K for 2005 at 9.

independent verification.[314] The risks associated with making loans on a "stated" basis were recognized by New Century personnel, one of whom stated to Senior Management in January 2005:

> To restate the obvious, a borrower's true income is not known on Stated Income loans so we are unable to actually determine the borrowers ability to afford a loan.

Despite such risks and despite the fact that New Century knew by January 2005 that Stated Income loans had a "significantly higher delinquency" rate than full documentation loans, Stated Income loans became an increasingly important part of New Century's mix of loan products. This trend caused a New Century employee to comment in an October 20, 2004 e-mail that was copied to Cloyd:

> Stated Income. This has been increasing dramatically to the point where Stated Income loans are the majority of production, and are teetering on being >50% of production. We know that Stated Income loans do not perform as well as Full Doc loans. (Emphasis supplied).

Notwithstanding these expressed concerns, Stated Income loans remained a high percentage of overall originations. Thus, the percentage of New Century loans in the Stated Income category as a percentage of total originations in the months noted below were as follows:

Month	**% Stated Income**
6/02	35.71%
12/02	34.09%
6/03	37.51%
12/03	42.46%
6/04	43.73%
12/04	43.50%
6/05	44.89%
12/05	45.51%
6/06	42.85%
12/06	47.24%

As will be discussed below, analyses in early 2006 established that Stated Income loans had very poor delinquency results. Despite such analyses, Stated Income loans remained a staple of New Century's loan originations.

[314] New Century personnel would sometimes seek to verify that a prospective borrower's statement of his/her stated income was reasonable, such as by checking surveys of average compensation in the region of persons with similar work profiles. However, the Examiner was told in several interviews that such inquiries were often discouraged.

The same individual who expressed concerns about Stated Income loans, also commented on other risks that he perceived in the products being offered by New Century in fall 2004:

> Risk Layering. Adding the risk factors on top of each other such as Stated – IO – 80/20.
>
> 80/20. Increasing population of 80/20 is driving up CLTV [combined loan to value ratios]. CLTV's are more important to default risk than straight LTV and while our LTVs are dropping, our CLTV's are increasing – thus increasing Default Risk....
>
> . . .
>
> Stated Wage Earners. While I believe this is being addressed somewhat, I just can't get comfortable with W2'd borrowers who are unwilling or unable to prove their income.

Another senior officer similarly wrote to Morrice on October 24, 2004, commenting that "stated wage earner loans present a very high risk of early payment defaults and are generally a lower credit quality borrower than our self employed stated borrowers."

New Century increased its risks in other ways as well. As noted above, a New Century executive expressed concerns about 80/20 loans. These were 100% LTV loans, with an 80% first lien and a 20% second lien. New Century tracked the percentages of its loans that were "core" or "traditional" loans, generally loans with LTV in the range of 80% or less, and its non-core loans at 100% LTV, which came to be dominated by the 80/20 loans.[315] The shift from core loans to 80/20 loans was dramatic, and starkly depicted the increasing risk profile of New Century's loans:

Month	**% Core**	**% 80/20**
3/03	88.13	7.9
12/03	83.00	9.10
6/04	77.93	19.08
12/04	74.98	23.54
6/05	65.50	33.83
12/05	64.26	35.23
6/06	64.81	34.77
12/06	68.42	29.22

[315] New Century had a 100% LTV product without the 80/20 structure but this product never had more than approximately a one percent share of New Century originations.

Risks associated with the 80/20 products became apparent as their originations grew. For example, Senior Management became aware in September 2005 that 80/20 loans of the 2004 vintage had four times the 60+ day (loan payments behind by 60 days or more) delinquency rates of non-80/20 products, underscoring the higher risks of this product.

The same trend toward higher risk was reflected in New Century's trend toward ever higher "combined LTV" ratios, meaning the total loans that a borrower had pertaining to the collateral compared to the appraised value of the collateral. As noted in the e-mail quoted above, a New Century executive noted that combined LTV ratios were increasing, therefore "increasing Default Risk . . . ." Those increasing values were as follows in the months listed below:

Month	**WACLTV**[316]
11/02	79.92%
3/03	82.2%
12/03	83.69%
6/04	83.77%
12/04	84.73%
6/05	86.92%
12/05	87.07%
6/06	87.45%
12/06	87.47%

As shown, there was a consistent trend throughout the period to higher combined LTV ratios, with associated greater risks of borrower defaults.

New Century originated some higher risk subprime mortgage loans in response to the appetites of investors who were eager to buy these sorts of products, which tended to have higher interest rates than more conventional products. However, New Century also was a leader in the market on some higher risk mortgage loan products. For example, one product offered by New Century in 2004 was an interest only 80/20 stated wage earner loan, which as of October 2004 made up 3.4% of New Century's originations. Such a loan had multiple layers of risks: it was interest only; it was a 100% combined loan to value loan; and the borrower did not need to verify his/her income. Flanagan observed in 2004 that New Century appeared to be the only lender

[316] Weighted average combined loan to value ratio.

originating this layered risk loan.[317] Cloyd, who headed Secondary Marketing, recommended that such loans be eliminated. The Examiner found no evidence that this recommendation was accepted. Stated Income products remained a large component of New Century originations and as noted below, Stated Income products, including those in 80/20 products and in loans to single borrowers, were identified in early-2006 as extremely poor performing, high risk New Century loan products.

A further risk should be noted as well. New Century originated a large quantity of 2/28 and 3/27 ARM. Typically, these ARM would have a fixed low interest rate (often called a teaser rate) for the first two or three years and then would adjust at least annually thereafter, with the adjustment tied to an index such as LIBOR.[318] Even if the index rate did not change over the two or three year fixed rate period, the loan payments would be expected to increase at the first adjustment date. New Century qualified its borrowers for such loans on the basis of their ability to pay the loan at the initial teaser rate, rather than the ability to pay the loan at the indexed rate after the initial fixed rate period. This circumstance presented an obvious risk of future default, which was specifically identified by New Century personnel. Thus, in discussing the 2/28 IO product in fall 2004, New Century's General Counsel identified the potential "sticker shock" risk associated with this product:

> [T]he 2/28 IO product results in significant "sticker shock" at month 25 even with relatively modest increases in LIBOR during that period. For example, a 57 basis point increase in the interest rate over that period results in a 25 percent jump in the monthly payment amount for that borrower. In contrast, the traditional 2/28 borrower will only experience a 6% payment increase.
>
> This sticker shock, when combined with lower credit grades (down to 580), higher DTIs [debt to income ratios](as high as 50%), a high concentration of stated wage earners, a high concentration of 80/20 product, higher LTVs and other risk factors led the FLAT [Fair Lending Action Team] members to be concerned that a meaningful percentage of these loans might present serious repayment ability issues. The sense from my conversations with people in the field is that many of these loans are being sold to borrowers with the expectation that the borrower will be able to refi in a couple years. While that is certainly a valid choice for a borrower to consider or a broker to suggest, we should not be making loans where the inability to refinance after 2 years leaves the borrower at very high risk of default even under modest interest rate increases.

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[317] Layered risk refers to the combination of one higher risk product, such as interest only loans, with another higher risk product, such as stated income loans.

[318] London Interbank Offered Rate.

Similarly, in early-2005, New Century personnel again noted the risk of defaults on New Century's ARM:

> The most common subprime product is a loan that is fixed for 2 or 3 years and then becomes adjustable. The initial rate is far below the fully-indexed rate, but the loan is underwritten to the start payment. At month 25 the borrower faces a major payment shock, even if the underlying index has not changed. This forces the borrower into a refinance, likely with another subprime lender or broker. The borrower pays another 4 or 5 points (out of their equity), and rolls into another 2/28 loan, thereby buying 2 more years of life, but essentially perpetuating a cycle of repeated refinance and loss of equity to greedy lenders.
>
> Inevitably, the borrower lacks enough equity to continue this cycle (absent rapidly rising property values) and ends up having to sell the house or face foreclosure.

In sum, New Century was aware that it was offering a variety of products that contained elements of high risk, especially when various risk factors were layered together. At the end of 2005, New Century prepared a Summary of "2005 Loans Characteristics and Delinquency Performance." The Summary set forth in stark detail the increasingly risky loans made by New Century in 2005 when compared to earlier years:

> Overall, the 60+ delinquency on the 2005 vintage is higher than the 2003/2004 vintages, but lower than the combined pre-2003 vintages.
>
> The 60+ delinquency on the 2005 vintage for 650+ FICO bucket is equal to or higher than any of the other vintages.
>
> Production characteristics (since 2003):
>
> > Stated Income loans and 80/20 loans are increasing
> >
> > The volume of loans with only one borrower is increasing, especially in the higher FICOs
> >
> > Stated Income loans with one borrower have doubled since 2003, while Full Doc loans with more than one borrower have declined by 1/3
> >
> > CLTVs are highest on Stated Income loans with one borrower
> >
> > FICOs are highest on Stated Income loans
>
> Specific Performance Indicators
>
> > 80/20s perform worse than Core loans
> >
> > Stated Income loans perform worse than Full Doc loans
> >
> > Loans with one borrower perform worse than loans with 2 or more borrowers
> >
> > Stated income\80/20 loans with one borrower have terrible performance relative to other loans in the same FICO band, while Full Doc\Core\Joint loans have superior results

> **Overall, our volume has moved into loan cohorts that have weaker performance. As a result of the higher volume coming from those poorer performing buckets, our delinquency rates are being negatively impacted.**

(emphasis in original) These data evidence the ever-increasing risks incurred by New Century – a veritable ticking time bomb. Under the circumstances, New Century should have been more concerned about – and taken greater steps to address – loan quality issues.

D. Measuring Loan Quality at New Century

The Examiner investigated to determine how New Century measured loan quality in 2004 through 2007. This was important so that the Examiner could reach a judgment whether New Century responded appropriately when data relied upon by New Century suggested deteriorations in loan quality that might have prompted more intense scrutiny and greater action by New Century's Management and its Board of Directors.

The Examiner determined that New Century never adopted specific criteria for measuring loan quality. In September 2004, Morrice commented to Senior Management that "we have historically been . . . unclear about how to measure loan quality and whether it is getting better." In responding to Morrice, New Century's Chief Credit Officer observed that New Century had "no standard for 'loan quality'" and observed that New Century needed "to decide what we want our driver(s) to be."

Even though New Century never appears to have explicitly adopted specific criteria for measuring loan quality, the Examiner determined that there were two basic types of measurements by which New Century sought to assess the quality of its loans. The first set of measurements were factors that affected New Century's profitability in a relatively direct way, such as: loan delinquency rates, including EPD; repurchases; and Secondary Marketing performance, including kickout rates and the prices that New Century received on the sale of loans. The second set of measurements were derived from internal New Century data, such as the results of audits by the Quality Assurance and Internal Audit Departments.

1. Delinquency Rates, Including Early Payment Default Rates

New Century would regularly track loan delinquency rates in several different ways. These data were relied upon by New Century as an important loan quality measurement.

New Century tracked the frequency with which borrowers defaulted on newly funded loans. New Century would track first, second and third payment defaults, which it collectively

called EPD. FPD appear to have been most important to New Century personnel tracking such data, with one employee commenting to Cloyd in December 2004: "FPDs are a clear indicator of loan performance and the earliest possible objective measure that we have." (emphasis in original). These FPD data were of particular importance because, under its loan purchase agreements with investors, New Century could be required to repurchase loans when there were early defaults by borrowers. Such EPD were also important because New Century securitized on its balance sheet billions of dollars of loans. If loans went into default, especially soon after they were securitized, then New Century's expected interest income would be reduced.

The Examiner could not determine whether New Century ever adopted targets for acceptable EPD rates, although at various times certain targets were mentioned. For example, in October 2005, the Credit Department advised the Audit Committee that its immediate targets for FPD and second payment defaults ("SPD") were two and five percent, respectively, and that its longer-term target for such defaults were 1.5 and five percent, respectively. However, in June 2006, Cloyd stated that FPD should be no more than one percent.

These sorts of defaults were tracked regularly by New Century, and a New Century officer advised the Audit Committee in October 2005 that FPD and SPD default rates were "recognized in the industry as an indicator of quality." The Examiner recognizes that even with the best loan origination processes in terms of qualifying borrowers for loans, some level of EPD were bound to occur. From all the data available to the Examiner, it appears that New Century wanted FPD to be no more than approximately one percent and looked closely at trends among all categories of EPD as a loan quality metric.

New Century also devoted effort to track longer-term delinquency rates among various New Century vintages. New Century did not appear to have established targets for acceptable long-term delinquency rates. However, through use of commercially available data, New Century compared its delinquency rates against the rates reported for competitors in the subprime industry. New Century personnel believed that its loan quality was better than its competitors over most time periods based on such comparative data. While no one informed the Examiner that this was a metric for judging loan quality, the Examiner believes that one factor in New Century's failure for so long to make loan quality a greater priority was its belief that its loan quality in terms of delinquency rates was better than the competition.

2. Secondary Marketing Performance

Secondary Marketing's ability to sell loans at a premium was an important loan quality metric. This metric had two main components.

The first component, and the one most directly connected to loan quality, was the kickout rate. As noted previously, investors would conduct due diligence on loan pools and reject, or "kickout," loans that they did not wish to purchase. Starting no later than late 2002 or early 2003, New Century began to track monthly sales success in terms of kickouts and would circulate to a large group within New Century so-called kickout or fallout reports. Although these reports evolved over time, they generally consisted of a summary report that identified the overall percent of loans that had been kicked out by investors in a particular month and then summarized the principal reasons for the kickouts, such as defective appraisals, income to debt ratios that conflicted with underwriting guidelines, incorrect credit reports, missing documentation and compliance issues. There also were detailed spreadsheets attached to these reports by which persons could identify the precise reasons given by investors for kicking out each particular loan.

Loan files that were missing required documentation were a persistent cause of investor kickouts starting no later than 2004 and continuing through 2007. From April 2004 to January 2007, investors rejected an estimated $1.17 billion worth of loans due to missing documentation.[319] For example, investors consistently rejected loans that had missing or incomplete documentation, such as current pay stubs, on full document loans; missing 12-month mortgage or rental histories; unresolved title issues, including missing evidence that tax liens or judgments had been released on the subject property; missing legal and compliance documents, such as a copy of the promissory note, Truth-in-Lending forms, Good Faith Estimates or HUD-1 settlement statements; missing or incomplete loan applications (the "Form 1003") used to verify

[319] The format of New Century's monthly Fallout Reports varied from 2004 to 2007. As a result, consistent data were not always available to the Examiner. In general, the Fallout Reports reported on missing appraisal documentation and on "all other" missing loan documentation. From July 2004 to December 2006, the Fallout Reports provided data on the "all other" missing documentation category in 29 of the 30 months. Itemized data on missing appraisal documentation were not always provided. For example, in 2004, the statistics on missing appraisal documentation were combined with the "other property issues" category, including unacceptable property types, conditions, or square footage exceptions. Itemized data on missing appraisal documentation were not available for seven months in 2005 and 11 months in 2006; in these months, the Examiner applied an estimate cited by the manager of investor due diligence that approximately 10% of all appraisal kickouts were due to missing appraisal documentation. For the years 2005 and 2006, this estimate totaled $203,263,332.

a borrower's income on a stated document loan; and missing appraisal certificates of completion.[320]

New Century did not adopt a target for a maximum acceptable rate of kickouts before the summer of 2006, when a five percent target was identified in the so-called scorecard reports. Flanagan in an e-mail from April 2005 suggested that kickouts should not exceed 2.5% of the loans in any pool. The Examiner believes that such a rate was probably more aspirational than real, and a senior executive wrote in 2006 that "[i]nvestor rejects run about 3 to 4% in best markets . . . ." Information made available to the Examiner suggests that a kickout rate under five percent was what was viewed as generally acceptable and that anything above five percent was viewed as too high.

The Examiner makes three observations pertaining to kickout data. First, the Examiner was told consistently during his investigation, and the review of many documents confirmed, that the amount of due diligence conducted by investors varied depending on whether the investors were whole loan purchasers or securitization trusts. Whole loan purchasers conducted significantly greater due diligence than securitization trusts, with the reason being that in securitizations, New Century bore the residual credit risk. In any event, in months in which fallout rates were reported to be low, those months tended to have a larger percent of securitizations than other months. For example, the reported kickout rate in April 2005 was 1.31%, with the rates in March and May 2005 being 4.98% and 6.03%, respectively. It turns out that 82% of the premium loan sales in April 2005 were to the 2005 NC-2 securitization trust, which explains the very low fallout rate for that month. The kickout rate in April 2005 for whole loan sales alone was 5.59%.

Second, kickout data may not be a true indication of loan quality trends because New Century was able, particularly when the subprime market was strong and housing prices were rising, to negotiate understandings with certain loan purchasers to limit kickouts to a maximum rate, such as 2.5%. Flanagan was explicit in stating to the Examiner that such understandings were reached. The Examiner was unable to establish corroboration for this statement. Nevertheless, such understandings may have limited kickouts, masking loan quality problems that existed but were not reported.

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[320] The certificate of completion, or "Form 442", was required when a property's appraisal value was subject to a condition, such as the completion of a home remodeling project or the completion of a new home construction.

Third, the Examiner was told by many interviewees that investors became more discerning and discriminating over time in the due diligence process as the downturn in the subprime mortgage market grew more apparent. Accordingly, although kickout rates increased steadily in 2005 and 2006, that does not necessarily mean that the quality of New Century loans was getting worse. Rather, at least part of the reason for the increased kickout rates may have been the greater degree of due diligence carried out by investors, as well as investors' reluctance to purchase certain sorts of loans, irrespective of loan origination process issues, because of a decreasing appetite for the purchase of higher risk loans.

The other metric of Secondary Marketing performance was the price that New Century received on loan sales. It was a regular practice in the monthly Capital Markets Reports that were widely circulated to Senior Management for Secondary Marketing to report to a large number of persons on the total average premium received on loan sales in any month. It is not clear that this metric was explicitly tied to loan quality, as there could be non-loan quality reasons why lower premium prices were achieved in a particular month, such as investors having less of an appetite to purchase large quantities of certain types of subprime loans.

3. Repurchases

Repurchase claims and actual payments made to repurchase loans were identified by Senior Management in 2004 as another possible metric by which to measure loan quality. Indeed, Morrice in a September 24, 2004 memorandum to senior colleagues, specifically identified repurchases as one of the metrics that he favored tracking in assessing the quality of New Century loans. Cloyd concurred.

Notwithstanding these views, repurchase claims and actual repurchase payments apparently did not receive much attention and were not used as a metric to measure loan quality until some time in 2006. This is surprising for two reasons: (1) repurchases resulted most often from early borrower defaults; and (2) available data show that there was a spike in repurchase payments starting in the second quarter of 2005, from approximately $25 million per quarter to approximately $100 million per quarter in the second quarter of 2005 and the remainder of that year.

There are several possible reasons why repurchases were not tracked before mid-2006 as a loan quality metric. First, as reported elsewhere in this Final Report, New Century did not have reliable data on the quantity of repurchase claims it received. Second, in 2004 and 2005, by

historic averages (assuming the averages are accurate), the levels of actual repurchases were relatively low, although they doubled in 2005. New Century's historic repurchase data were as follows:

Year	Repurchases as a % of total loans sold
2002	1.47%
2003	0.37%
2004	0.34%
2005	0.63%
2006	1.35%

Indeed, Dodge commented in September 2006, by which time repurchases were clearly on New Century's radar screen, that repurchases in "2005 represented a very low level by historic standards."[321]

4. Internal Loan Quality Measurements

New Century had internal means to track loan quality. The most important means are summarized below.

a. Quality Assurance Department Audits

The New Century Quality Assurance Department regularly audited the New Century loan origination processes. These were monthly post-funding audits whereby the Quality Assurance Department would audit between 7.5 and nine percent of funded loans to determine if the loan files evidenced compliance with applicable New Century requirements. The audit results would then be reported to the Production Department and there were periodic reports provided to the Audit Committee. The Quality Assurance audit results tended to identify the same sorts of problems as identified in the kickout reports, such as faulty appraisals, undocumented exceptions to underwriting guidelines and missing documentation from loan files.

Given that the Quality Assurance audit results appeared closely to track the types of data documented in kickout reports, the Examiner expected that Quality Assurance audit results would have been a significant metric of loan quality. However, the audits by the Quality Assurance Department were not an important metric used by Senior Management in assessing New Century loan quality. First, since such post-funding audits did not directly affect profitability, some in Management discounted their importance. For example, in a September

[321] The Examiner has found that a significant back-log of claims submitted existed as of 2005 year-end.

24, 2004 memorandum to others in Senior Management, Morrice addressed the then-existing loan quality scorecard, which was a device used to attempt to track the quality of New Century loans. He stated:

> I believe it is consistent to focus our [loan quality] measurement process on objective outcomes (secondary results and loan performance), rather than subjective opinions (like re-underwriting and exception rates that are not correlated to loan sale/performance results).
>
> Accordingly, I would suggest that our Loan Quality Scorecard (LQS) be simplified by eliminating (i) QA report results, (ii) exception rates, (iii) percentage of appraisals in different Hansen risk categories, and (iv) zero defects. This information is probably worth tracking and working on for other reasons and we may want QA reports relative to compliance issues, but I would no longer report this information on the LQS. (emphasis added)

Second, some at New Century questioned the quality of the New Century Quality Assurance Department in 2004 and 2005. The Internal Audit Department audited the performance of the Quality Assurance Department in 2004 and found that its operations were inefficient and that its results were not always reliable. Thereafter, in March 2005, an individual from the General Counsel's office who had been tasked to assess the Quality Assurance Department, summarized his views as follows:

> In my view the current QA function is weak because there is a:
>
> lack of QA knowledge and experience on part of current QA management
>
> lack of quality QA system-Brain is a poor QA system at best
>
> lack of QA knowledge and experience on part of current auditing staff
>
> lack of clear-cut QA Plan
>
> lack of fraud detection capability
>
> lack of appropriate sampling size and stratification by
>
> product type
>
> origination channel
>
> fulfillment channel
>
> geographic
>
> lack of meaningful resolution of audit findings (QC Committee)

Pursuant to this individual's recommendations, and after making a report to the Audit Committee on May 17, 2005, the Quality Assurance Department was dissolved in September 2005, most of its personnel were laid off and the Quality Assurance function was then outsourced while a new

Quality Assurance Department was developed under new leadership.[322] This new Quality Assurance Department began to function in mid-2006.

b. Internal Audit Reports[323]

In terms of loan quality, beginning in late 2004 and continuing in 2005, Internal Audit conducted so-called field audits to assess whether the loan origination processes in New Century's wholesale fulfillment centers and retail offices were being conducted in accordance with existing policies and procedures. The Internal Audit Department's results consistently reported that the loan origination processes had significant flaws. For example, in an audit dated September 19, 2005, the Internal Audit Department identified countless deficiencies in loan files it reviewed at a retail production center, including that 29 of 100 files had missing or improper RESPA[324] disclosures and that 18 of the 100 files were missing or had incomplete documents required by state law.

The Internal Audit Department's results, however, did not figure heavily in measuring loan quality prior to 2006. First, just like the Quality Assurance Department's results, the Internal Audit Department's findings did not directly affect New Century profitability in the way that kickouts and EPD could affect profitability. Accordingly, such subjective measurements of loan quality apparently carried relatively little weight within New Century.

Second, the Production Department was focused on originating ever larger volumes of loans at ever lower costs. The Production Department viewed Internal Audit as an entity that increased the average cost to originate new loans. As of June 30, 2005, New Century estimated that its total cost per funded loan was $505. Flanagan in August 2005 set a cost goal of $400 per funded loan by the end of 2005 and, among other things, sought to cut the Internal Audit contribution to such costs, estimated at $26/loan, to no more than $15/loan, remarking:

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[322] The Examiner sought to determine whether there was an effective Quality Assurance Department/function in effect between September 2005 and June 2006 when the new Quality Assurance Department commenced audits. The results were inconclusive, but suggested that the Quality Assurance function in the interim was limited at best and the results of the outsourced Quality Assurance audits were not viewed as reliable.

[323] The Internal Audit function is addressed elsewhere in this Final Report and that discussion will not be repeated here.

[324] RESPA, or the Real Estate Settlement Procedures Act, is a consumer protection statute which requires that borrowers receive certain disclosures regarding closing costs and settlement procedures at specified times during the real estate transaction.

Internal Audit

- Cost is too high
- Accuracy of the results is questionable
- Don't know what we are getting for our $ spent
- Group is out of control and tries to dictate business practices instead of audit against policy[325]

In a later e-mail from Flanagan in September 2005, Flanagan's disdain for Internal Audit was unmistakable. Writing soon after a loan processing center had received an "Unsatisfactory" rating in an Internal Audit Department field audit, Flanagan stated:

> I think the group who are receiving this e-mail needs to get together and discuss the operating center audits. If recollection is correct, ever singe [sic] audit completed has been unsatisfactory which to me sounds like we need to ammend [sic] policy as much as clean up our act. The financial results that have been ackomplished [sic] over the past few years are inconsistent with the audit results.

Flanagan's message was clear. The Production Department's results in generating revenue made the Internal Audit Department's results unimportant.

E. Loan Quality in 2004

In 2004, New Century increased its loan originations by 54% compared to 2003, originating $42.2 billion in loans compared to $27.4 billion a year earlier. In the context of such strong growth in originations, loan quality trends were mixed but decidedly negative. EPD increased from mid-2004 until the end of the year, as did investor kickouts. Similarly, the New Century Quality Assurance Department reported loan origination process deficiencies, which mirrored the problems identified by investors in kicking out or rejecting New Century loans.

In response to these trends, loan quality became a frequent topic of discussion among members of Senior Management and the Audit Committee, particularly after rising interest rates in June 2004 signaled that tougher operating conditions appeared likely. However, improving loan quality did not become a priority in 2004. No one was directed to address the disturbing trends and there was no concerted effort to address certain arguably fixable problem areas, particularly on process issues, such as documenting reasons for exceptions and making sure there

[325] Production sought to reduce costs associated with other departments as well at the same time. But, the percentage cuts for Internal Audit were far larger than any other proposed cuts. The Examiner was unable to determine whether these proposed cost cuts were carried out.

were no documents missing from a loan file at the time of loan funding, which were frequent reasons investors were rejecting loans in whole loan sales.

1. Loan Quality Trends in 2004

a. Early Payment Defaults

The trends in 2004 for EPD, including FPD, were negative, particularly from the middle of the year onward. The data for 2004 were as follows:

	FPD	EPD
January	1.02%	6.40%
February	0.71%	6.32%
March	0.53%	4.23%
April	0.62%	4.53%
May	0.86%	8.20%
June	0.92%	7.62%
July	1.13%	7.91%
August	0.94%	7.06%
September	1.20%	8.76%
October	1.39%	9.70%
November	1.35%	10.02%
December	1.31%	8.72%

The upward trend of EPD did not go unnoticed. In an October 2004 e-mail copied to Cloyd, a New Century employee, in addressing various risks facing New Century in the types of products it was offering and citing the factors that the employee considered to be "troublesome," stated: "Early Defaults: This key indicator is increasing." (emphasis added). And the same employee commented in December 2004:

> We have seen FPDs increasing rapidly and steadily since the low of .53% in March, reaching 1.39% in October, before falling slightly to 1.35% in November.

Shortly thereafter, the Secondary Marketing Department circulated the following summary of EPD in 2004 compared to 2003, showing the marked increase and financial consequences in all categories of EPD:

Early Payment Default Summary

	2003		2004			
	Dollar	%	Dollar	%	Difference	% Increase
FPD	103,873,250	0.60%	338,789,455	0.93%	0.33%	54%
SPD	140,216,425	1.95%	778,319,627	2.92%	0.97%	50%
TPD[326]	68,718,595	1.83%	704,586,688	3.39%	1.57%	86%
Total EPD	312,808,270	4.38%	1,821,695,770	7.24%	2.86%	65%

This summary documented the significant deterioration of New Century loan quality, as measured by EPD, in the first, FPD, SPD and TPD categories in 2004 when compared to 2003, and the large financial impact of such defaults.

b. Kickouts

As discussed here and elsewhere in this Final Report, kickouts represent, for the most part, loan origination process issues caused by New Century loan production and operations personnel not doing their jobs as expected or in accordance with the Company's underwriting policies and procedures. These policy issues were perpetuated by Management, who, month after month, tolerated this inattention to those policies and procedures.

The kickout problems began no later than 2003. For example, between April and December 2003, kickout rates on whole loan sales ranged from a low of 4.41% to a high of 7.24% in September 2003 and the monthly average was 5.83%. The August results of 6.70% were sufficiently severe that the Senior Vice President in the Company's Secondary Marketing Department prepared a report on the investor due diligence process and the number of loans that investors kicked out from the August 2003 loan pools. The author planned a more comprehensive report in due course but stated that she "did not want to wait until the 10th [of the month] to share this information with you as each day we continue to allow these types of exceptions and mistakes we not only erode the profitability of our loans but the confidence of our investors. Weakening credit quality is the number one concern for our investors." The author reported that the primary reasons for loan kickouts included unsupportable underwriting exceptions for maximum loan amount, LTV ratios, FICO scores and debt-to-income ("DTI") ratios, missing documentation, and income miscalculation. The majority of the loan kickouts in

[326] Third payment default.

August 2003 resulted from missing documentation; the report also noted that LTV exceptions "exceeded [the] maximum allowed by 10% to as high as 65% in some cases."

Concerns over investor kickouts escalated in 2004. Kickout rates on whole loan sales for the months of 2004 for which the Examiner has data were as follows:

2004 Kickouts

		Value of Kicked Loans
January	6.35%	$172,646,148
February	5.45%	$164,250,580
March	6.92%	$132,783,341
April		
May	5.22%	
June		
July	7.17%	$250,586,173
August	5.56%	$211,388,971
September	5.65%	$ 94,917,107
October	5.55%	$185,796,482
November	5.15%	$120,608,953
December	5.35%	$172,592,474
TOTAL		**$1,505,570,229**

The average monthly rate in 2004 was the same as the last nine months of 2003, namely 5.83%.

The same sorts of problems that had been identified in 2003 as causing kickouts were again reported in 2004. For example, in July 2004, investors rejected 7.17% of the loans that New Century sought to sell.[327] There were various reasons listed for the July kickouts, including:

> Property value and appraisal documentation issues. $67,868,537 of loans were rejected in July 2004 due to unsupported property values and another $11,672,387 were rejected due to missing appraisal documentation.
>
> Problems with income and debt ratios accounted for $19,871,113 of July rejections.
>
> Other problems that led to investor rejections included:

[327] The Examiner was unable to locate quantified kickout data in 2004 for months prior to July 2004, except for a reference to a 5.22% kickout rate in May 2004.

Unacceptable exceptions related to borrowers' mortgage or rental payment histories and credit grades

LTV ratios that exceeded guidelines

Non-arm's length transactions

Missing documentation

Compliance issues.

From July through December 2004, investors rejected approximately $126 million in loans due to missing documentation alone. These kickouts accounted for over 12% of the investor kickouts for this time period.

In a September 7, 2004 e-mail to many persons in the New Century Production, Operations and Secondary Marketing Departments, the officer responsible for the kickout reports stated as follows concerning the July 2004 kickout rate:

> We are unfortunately seeing a very concerning trend in both Appraisal and Credit quality . . . .
>
> This could be an anomaly in that June [2004] production (our largest month) made up a substantial portion of the population, but I ask that we not assume that to be the case. This severe of a drop in execution clearly warrants a legitimate concern on everyone's part and we are asking that each of you review carefully the information contained and take action within your area of responsibility to insure future months are greatly improved.

Following up on these kickout rates, a senior New Century employee commented about loan sale issues, stating as follows:

> The number one issue is exceptions to guidelines; for DTI, Mortgage/Rental rating, Credit Grade, loan amounts (in August those exceptions were in excess of $20mm). Part of this can be attributed to the fact that generally in these instances the underwriting staff did not do a very good job, if any attempt at all, at documenting the reasons for making the exception. As well, due to the absences of clear and comprehensive exception policy and underwriting policy/guidelines, we exacerbate the issue. Ambiguity (in guidelines) may have been common and even acceptable in the past, but in today's environment it is not by the investment community and it is becoming evident that it may very well be the root cause in many of our issues surrounding credit quality. (emphasis in original)

This demonstrates recognition within New Century that there was substantial room for improvement in the quality of the Company's loan origination processes in 2004.

c. Quality Assurance Department Findings in 2003 and 2004

New Century's Quality Assurance Department repeatedly identified problems in the loan origination processes beginning in 2003, which mirrored the reasons that investors were kicking

out loans in whole loan sales. For example, in June 2004, the Quality Assurance Department provided the Audit Committee a summary report of its 2003 Quality Assurance findings pertaining to the New Century loan origination processes. The Quality Assurance Department reported that it had identified a high percentage of errors in New Century's underwriting related to loan credit grading and a high percentage of compliance errors, such as the failure of persons to have signed legal documentation. Quality Assurance reported that severe underwriting errors, defined as errors that could impact loan salability due to credit issues, predatory lending, legal, state violations and other compliance issues, were found in almost 25% of the loans audited in November and December 2003, and in approximately 12 to 17% of the loans from June to October 2003. The number of loans with severe compliance defects ranged from approximately eight percent of the June 2003 loans to 16% of the December 2003 loans. After reviewing the report and discussing its content with Senior Management, "[t]he [Audit] Committee expressed concerns with respect to many of the issues listed on the QA Report . . . ."

Prior to the release of the 2003 Quality Assurance results to the Audit Committee, New Century Senior Management discussed the early- 2004 Quality Assurance results, stating that while Quality Assurance results were somewhat improved in early-2004 as compared to 2003, they were "still at unacceptable levels" as of March 2004, and that the same sorts of problems identified in the kickout reports were being reported by Quality Assurance. Thus, from January 2004 through March 2004, approximately 16 to 21% of the audited loans were determined to have had moderate to high risk underwriting defects. Further, approximately 14 to 15% of loans in April and May 2004 had high risk compliance defects.

The negative Quality Assurance findings continued in the second half of 2004. In March 2005, the Quality Assurance Department issued a 2004 Year-End Quality Assurance Trends and Update Report. Quality Assurance audited approximately seven percent of the wholesale production volume and 11% of the retail production volume during its 2004 audits. The Quality Assurance Department reported: "[t]here has been a significant spike in the high-risk defect rates in our underwriting audit[s] in the last several months of the year." From April 2004 to October 2004, the percentage of loans with high risk underwriting errors increased from approximately 12.5% to 15%. By December, the number of errors had significantly increased, and underwriting errors were identified in approximately 24% of the loans. The most prevalent underwriting

defects included credit misgrading, missing mortgage or rental verification, errors in the DTI ratio calculation and missing documentation.

2. New Century's Efforts to Improve Loan Quality in 2004

In view of the troubling loan quality trends evident in 2004, the Examiner investigated whether New Century gave sufficient attention to improving loan quality. The Examiner determined that loan quality was a frequent topic of discussion, both among Senior Management and at Audit Committee meetings. However, those discussions led to no meaningful action plan to address issues. No person or persons were assigned responsibility for addressing loan quality issues, including process issues, such as documents missing from loan files, a problem that could have been fixed fairly easily according to persons interviewed by the Examiner. Such issues were not fixed and the problems that were reported to have caused the kickouts and adverse Quality Assurance Department findings persisted. The Examiner makes a number of observations about New Century's reaction to loan quality issues in 2004.

First, in response to the negative Quality Assurance findings, QA set up monthly meetings with the Production Department. In a May 25, 2004 Memorandum to the Audit Committee, the meetings were described as follows:

> In January 2004, the QA Department implemented monthly "Quality Meetings" to discuss detailed QA results with each operation for underwriting and funding the loans. The focus of the meetings is to discuss "root causes" and corrective actions required by specific operations groups on deficiencies reported. Senior operating management and the Chief Credit Officer participate in each meeting. In addition, targeted audits to monitor and follow-up on serious exceptions are now in place. Future reporting on these follow-up reviews will address exceptions not corrected and will identify the responsible operating groups.

The Examiner learned in his investigation that these "Quality Meetings" and other efforts by the Quality Assurance Department to address loan quality were not well received and were largely ineffective.

Second, the Audit Committee and the Board addressed loan quality on several occasions in 2004 appear to have been similarly ineffective. For instance, on June 2, 2004, the Audit Committee heard the report on the Quality Assurance Department audit results in 2003 and also received a report about the continuing Quality Assurance Department efforts in 2004, including a description of the Quality Meetings discussed above. The Committee is reported in the Minutes to have asked questions about "credit grades, the underwriting process and training issues" and to have "expressed concerns with respect to many of the issues listed on the QA Report,

including the process for implementing mortgage history updates prior to funding and to have asked that Senior Management periodically update the Committee on QA matters." Loan quality issues then appear to have been discussed at the Board meeting that took place on June 2-3, 2004, with the minutes noting that Senior Management answered questions regarding how loan quality might impact volume.

The Audit Committee continued to monitor loan quality issues during the remainder of 2004, consistent with its request at the June 2 meeting to get periodic updates. For example, at the August 17, 2004 Audit Committee meeting, the Committee received an update on Quality Assurance Department findings for January through May 2004, with the Committee being informed that "credit grading errors had decreased since the last quality assurance summary report provided to the Committee, which contained audit results for the year ended December 2003." The minutes then go on to state:

> Management and the Committee then discussed ways to incentivize or penalize employees to ensure increased focus on loan quality rather than just production volume. Mr. Flanagan reported that the bonuses of region managers in 2005 would be based in part on loan quality.

The Examiner found no evidence, however, that regional managers' compensation was directly tied to loan quality in 2005. Indeed, even in 2006, the bonus compensation system for regional managers made no reference to loan quality. Rather, the 2006 bonus for regional managers was 30% based on volume, 30% based on deviations from rate sheets, 30% based on the number of funding brokers utilized and 10% based on Senior Management's discretion.

Third, the Audit Committee and the Board appear to have addressed only a limited number of the loan quality issues that were apparent in 2004. As noted, there were increases in EPD and kickout rates in mid-2004, with those higher rates continuing for the remainder of 2004. If loan quality had been a significant priority for New Century's Board, the Examiner believes that such troubling trends would have been mentioned in Board and Audit Committee minutes. There is no such mention in the minutes reviewed by the Examiner.

Fourth, Senior Management, like the Audit Committee, did not make loan quality improvement a priority in 2004. Despite the negative trends in EPD and kickouts, apparently no significant efforts were undertaken by Senior Management to address the issues. Kickout reports were circulated monthly to a wide group, but no concerted effort was undertaken to fix the problems that resulted in kickouts above five percent month after month.

Fifth, Senior Management personnel in October 2004 exchanged views on the increasing risks inherent in the types of mortgage loan products New Century was originating in increasing quantities. The upshot of those discussions was no action. New Century continued in 2004 and 2005 to concentrate originations in the layered risk products that presented the greatest risks, particularly the Stated Income and 80/20 products. Senior Management appears to have been mindful that such products exposed New Century to risks beyond those presented in earlier years, but the Examiner could discern no efforts made to address such risks in any concerted manner.

F. Loan Quality in 2005

New Century's failure to focus on loan quality in 2005 was virtually identical to 2004. However, the problems and issues grew more severe in 2005, making the inaction all the more difficult to understand. The trends that became apparent in 2004, particularly higher EPD and kickouts, continued in 2005. In response, Senior Management and the Audit Committee devoted some time to discussions of loan quality, although such attention appears to have been no greater in 2005 than it had been in 2004. Improvement of loan quality in 2005 was not made a priority and no one in Senior Management was directed to be responsible and accountable for improving loan quality or correcting known problems with loan quality. As a result, loan quality worsened in 2005, with delinquency rates for many categories of 2005 loans much worse than similar products originated in 2003 and 2004.

1. 2005 Trends Demonstrated Worsening Loan Quality

a. Early Payment Defaults and Other Delinquencies Continued at High Levels

As noted previously, EPD were on the rise in the second half of 2004, finishing the year at 8.72%. FPD, the type tracked most closely by New Century, stood at 1.31% at year-end 2004. 2005 began much the same as 2004 ended, with EPD in January 2005 at 8.05% and FPD at 1.07%. The trend then improved for a couple of months, dropping to a low of 4.47% for EPD (and 0.64% for FPD) in March 2005. After March 2005, however, the trend in EPD and FPD grew worse again, and continued to deteriorate through the rest of the year:

Month	FPD Rate	EPD Rate
April	0.97%	6.58%
May	0.80%	6.66%
June	1.06%	7.00%

Month	FPD Rate	EPD Rate
July	1.20%	7.76%
August	1.02%	7.28%
September	1.37%	8.70%
October	1.15%	8.81%
November	0.95%	8.72%
December	1.42%	9.24%

The negative trends were promptly noticed. For example, in the April 2005 Capital Markets Report to Senior Management, one of the "Key Items Highlights" was as follows:

> First Payments Defaults increased by 31 bps to 0.97%. Total Early Defaults rose by 2.26 pctpts to 6.96%; this is the first month since November [2004] that Early Payment Defaults have increased. In total, 40,364 loans with first, second or third payments occurring in April were included.

The negative EPD rates continued to be reported regularly to Senior Management. For example, the July 2005 Capital Markets Report included the following comment:

> The percent of units with an Early Payment Default rose by 67 bps to 8.65%. The percent of units with a First Payment Default increased by 24 bps to 1.35%.

Indeed, the trend was of sufficient concern that it was reported to the Audit Committee at the October 25, 2005 meeting: "First Payment Defaults appear to be on the rise" and "Second Payment Defaults continue to rise as well. Going forward, it will be very important to monitor performance and see if this upward trend continues."

In addition, data available to New Century Senior Management in September 2005 indicated that the 80/20 loan product was, in the words of one employee, "performing worse than the other [New Century] products." New Century's Senior Management learned that the 80/20 loan product of the 2004 vintage had four times the 60+ day delinquency rates of non-80/20 products. In response to these data, the head of the Secondary Marketing Department queried, "thoughts on what to do with this information...pretty compelling." The Corporate Credit Officer concurred that the information was "very compelling," but the volume growth of the 80/20 product continued. Indeed, it was reported in the December 2005 Capital Markets Executive Summary Report that the volume of 80/20 loans had increased to 35.24% of overall loan production, compared to 23.54% at December 31, 2004 and 9.10% at December 31, 2003.

The negative delinquency trends became even more pronounced when Secondary Marketing Department personnel examined certain products originated in 2005 and compared them to similar products originated in 2004. Thus, in a 2005 Delinquency report prepared early

in 2006, the Secondary Marketing Department identified troubling delinquency trends in 2005 originations. For example, in comparing 2005 originations to those in 2003 and 2004, the Secondary Marketing Department reported as follows:

> 60+ Delinquency performance has deteriorated in 2005 versus the 2003-2004 vintages. Overall, the 2005 60+ delinquency at month 11 is twice as high as it was in 2003. 80/20 loans show similar trends and although they have higher FICOs, the delinquency is generally higher than the core products, across all vintages.

b. Kickout Rates Continued at High Levels

Just as EPD continued at high levels in 2005, so did investor kickouts. Investors rejected over $147 million worth of loans funded by New Century in January 2005 for an overall kickout rate of 5.64% in January. As in 2004, the top reasons for the investor kickouts reported in January 2005 were property value and appraisal documentation issues, which accounted for 44% of the kickouts, and compliance and excessive DTI ratios, which accounted for almost 10% and 7.5% of the kickouts, respectively. It should be noted that these figures may be artificially low as the Examiner was told by Flanagan that New Century negotiated limits on the amount of loans that some investors could kickout.

Overall, kickout rates for all of 2005 on whole loan sales stayed high, as shown by the following data:

2005 Kickouts (Whole Loan Sales)

Month	Kickout Rate
January	5.64%
February	5.92%
March	4.98%
April	5.59%
May	6.03%
June	5.59%
July	5.92%
August	4.57%
September	5.62%
October	8.11%
November	6.59%
December	8.77%

Just as troubling as the kickout rates was the huge dollar value of sales that were delayed or discounted, or never occurred, and the fact that the reasons for the kickouts tended to be the same sorts of problems, month after month, indicating that no effective attention had been devoted to correcting the recurring problems. These trends for 2005 can be summarized as follows:

Month	**Value of Kickouts**	**Top 3 Reasons for Kickouts**
January	$147,260,020	Property Values/appraisals (44.21%) Other[328] (21.49%) Compliance (9.76%)
February	$40,768,831	Other (47.79%) Compliance (18.63%) Property Value/Appraisal docs (15.96%)
March	$180,631,805	Other (33.72%) Property Value/Appraisal docs (23.72%) Compliance (15.88%)
April	$47,969,820	Other (41.91%) Property Value/Appraisal docs (18.13%) Other Credit[329] (10.38%)
May	$202,453,903	Property Value/Appraisal docs (30.97%) Other (23.79%) Compliance (12.71%)
June	$136,124,852[330]	
July	$169,164,290	Property Value/Appraisal docs (33.96%) Compliance (19.34%) Other (17.76%)
August	$129,850,097	Property Value/Appraisal docs (36.85%) Other (21.75%) Compliance (13.32%)
September	$283,044,874	Property Value/Appraisal docs (31.67%) Other (24.85%) Other Credit (15.72%)

[328] Other includes a category that included missing credit files and collateral packages and FPD.

[329] Other credit reasons include loans rejected due to loan amount exceptions, cash-out exceptions exceeding guidelines and non-arm's length transactions.

[330] The Examiner was unable to establish the top kickout reasons in June 2005.

Month	Value of Kickouts	Top 3 Reasons for Kickouts
October	$285,729,177	Property Value/Appraisal docs (32.38%) Other (18.11%) Compliance (15.58%)
November	$171,834,488	Other (25.47%) Property Value/Appraisal docs (22.67%) Missing Documentation (20.62%)
December	$486,915,048	Property Value/Appraisal docs (36.03%) Other (30.69%) Missing Documentation (9.21%)
Total:	**$2,281,747,205**	

As in 2004, over 12% of the investor kickouts in 2005, totaling approximately $280 million, were due to loan files that were missing required documentation – loans that never should have been funded until the files were complete.

c. Internal Audit Reported Troubling 2005 Loan Quality Trends

New Century's Internal Audit Department did not historically conduct audits of the Company's loan origination and production processes. That changed in 2005, resulting in findings that revealed serious deficiencies in those processes.

For example, in a June 17, 2005 audit of the Sacramento wholesale fulfillment center covering 77 loans originated in October through December 2004, the Internal Audit Department found many "High Risk" problems that could affect the salability of the loans. The findings from the Sacramento audit included:

35 (45%) of the loans had improper RESPA disclosures

32 (42%) of the loans did not have approval stipulations fully satisfied.[331]

26 (39%) of the loans had exceptions noted with income calculations and/or verification.

18 (23%) of the loans had exceptions with either the appraisal conducted or the review appraisal submitted with broker-provided loans or the review appraisal conducted by New Century's Appraisal Department.

[331] Approval stipulations are items or documents on which the lender needs further clarification or validation prior to closing a loan. An underwriter may conditionally approve a loan file subject to the specified approval stipulations being met. Once the additional data are gathered, the underwriter may remove the stipulations and approve the loan file.

Before the end of 2005, the Internal Audit Department completed nine such field audits, with seven receiving "Unsatisfactory" ratings and two receiving "Needs Improvement" ratings. The Examiner sought to determine precisely when each audit was conducted and reported to the Production Department. The Examiner could not make a precise determination, but it is clear that Production knew of at least a number of such "Unsatisfactory" findings well before the end of 2005. For example, the Sacramento Wholesale Fulfillment Center report discussed above was delivered to Production Department Management no later than June 17, 2005. The memorandum accompanying the audit included the following comments:

> The overall audit opinion based on this review is **Unsatisfactory**. Areas requiring immediate improvement include State and Federal Regulatory compliance, income calculations, satisfaction of approval stipulations, compliance to policies governing non-arms length transactions, adherence to down payment requirements on purchase money loans, assignment of proper credit grades and proper completion of the 1003 applications. (emphasis in original)

Similarly, the field audit results for the Itasca Retail Fulfillment Center were delivered to Production Management on September 19, 2005, along with a cover memorandum that summarized the findings:

> The Scope of the audit included loan origination processes for the period of February through April 2005. Other areas reviewed included associate expenses, State Licensing, and posters required by the Company and regulatory agencies.
>
> The overall audit opinion based on this review is **Unsatisfactory.** Areas requiring immediate improvement include Initial disclosure documentation, redisclosure requirements, satisfaction of underwriter approval stipulations, income calculations, adherence to hazard insurance requirements, and proper assignment of credit grades. (emphasis in original)

These Internal Audit Department field audit reports should have merited prompt Management attention from a loan quality improvement and assurance perspective. The sorts of problems that were identified repeatedly by the Internal Audit Department were the same sorts of problems that had been reported repeatedly to Management in the monthly loan kickout reports, documenting the reasons that investors were rejecting ever-increasing quantities of loans New Century sought to sell.

2. The Audit Committee and Management Devoted Little Attention to Improving Loan Quality in 2005

Trends reported above, such as high EPD and kickout rates and the field audit findings of the Internal Audit Department, all pointed to the fact that New Century had significant loan

quality problems. The Examiner believes that such loan quality problems should have prompted the Audit Committee and Senior Management to commence a serious effort to improve loan quality. That did not happen.

The Audit Committee held seven meetings in 2005 prior to October 25, 2005. Witnesses did not recall any discussion of loan quality and the minutes from those meetings do not reflect a single discussion of loan quality or of the need to improve loan quality. Similarly, a review of the minutes of the meetings of New Century's Board of Directors did not reflect any discussions of loan quality in all of 2005. The Audit Committee and Senior Management did address loan quality at the October 25, 2005 meeting, which is discussed below. Thereafter, however, loan quality was not addressed further at Audit Committee meetings in 2005. The negative field reports from the Internal Audit Department were on the Audit Committee agenda for the December 15, 2005 Audit Committee meeting and appear to have been briefly discussed, but the minutes report that "the Committee then decided to defer further discussion of Mr. Zalle's report regarding the Internal Audit Department's 2005 branch audit results until the next Committee meeting."

The October 25, 2005 Audit Committee meeting deserves more discussion because the Examiner determined from interviews, the minutes and various documents that there was a reasonably robust discussion of loan quality and acknowledgement by Senior Management and certain Directors that New Century had loan quality problems. The agenda for the meeting identified "Loan Quality Plan" as a specific discussion topic. The materials distributed in advance of the meeting included two documents relevant to loan quality. First, the Audit Committee received a document entitled "Credit Operations, Risk & Administration," disclosing that the Credit Operations, Risk and Administration Department ("Credit Department") had been reorganized in July 2005. Based upon the minutes, the Department's reorganization does not seem to have been discussed in detail. However, the referenced document made the point that "The Chief Credit Officer is independent of Production influences" and would be expected to monitor the performance of loans originated by New Century. The document also advised the Audit Committee that the Credit Department had developed an "Underwriter Performance Report" by which the performance of individual underwriters could be monitored and those responsible for approving defective loans, such as loans that were kicked out by investors or suffered EPD, could be identified. The intent was either to get better performance through

training or to restrict such underwriters' authority or even possibly to end their employment. The document stated: "Performance Improvement Training – improvement required to maintain authority levels and potentially employment at NC."

This Credit Department document, taken at face value, appears to be a start at addressing the types of loan quality issues reported in the monthly kickout reports and suggested by high EPD rates. However, this plan was not accepted by New Century Senior Management. The former Chief Credit Officer informed the Examiner that she presented this means of monitoring underwriter performance to Senior Management, and to Morrice specifically, but was not successful in persuading Senior Management to implement the system. This former employee was not certain why Senior Management resisted, but believed that they may have been influenced by the Production Department, which resisted changes that might impede rapid and high volume loan origination.

The second document provided to the Audit Committee at the October 25, 2005 meeting was an inaugural "Credit Quality Summary Report." In the report, the Chief Credit Officer advised the Committee and Senior Management that it would begin reporting regularly about loan quality using three basic metrics: Secondary Marketing Performance, meaning the percentage of loans in any month that were kicked out; significant Quality Assurance findings; and FPD and SPD. All of these data would be broken down by the separate New Century loan origination divisions and groups so that Senior Management would be able to identify quickly where loan quality problems were most serious.

The inaugural Credit Quality Summary Report summarized the results in the foregoing categories for July 2005, noting that kickouts had averaged 5.79%, Quality Assurance had found 24.9% of loan files to have serious defects, and FPD and SPD had been 1.34% and 4.22%, respectively. Similar to the Underwriter Performance Report, the Credit Quality Summary Report, at face value, looked as if it were the kind of report that could assist Senior Management to monitor loan quality and to take action as required. However, the report was discontinued immediately - the inaugural Report was the last report. No member of the Audit Committee or Senior Management appears ever to have inquired why the report was discontinued.

There was an extended discussion of the Loan Quality Plan at the October 25 meeting, led by Flanagan. The minutes indicate the following:

- Mr. Flanagan described Management's new methods for monitoring New Century's credit quality.
- The Credit Quality Summary Report was discussed and members of the Committee made suggestions about how it might be improved and made more timely and Management appeared to accept the suggestions.
- Mr. Flanagan stated that Management had developed an incentive plan for production managers to improve the credit quality of New Century's loans. The details of that plan were not described in the minutes.
- A member of the Audit Committee commented that "the percentage of loans originated by the Corporation that contained defects had traditionally been too high" and Mr. Flanagan is reported to have responded "that management was looking at methods to reduce the percentage of loans with defects."
- Mr. Flanagan reported that the QA Department had been laid off and that the QA function was being outsourced until "a more effective quality assurance team" could be assembled.

The seemingly frank discussion of loan quality issues at the October 25 meeting demonstrated an awareness that New Century's loan quality left much to be desired. However, the loan quality discussion at the October 25 meeting apparently led to no meaningful action. No person was charged with responsibility for addressing loan quality issues and reporting back to the Audit Committee. Indeed, it does not appear that any action came out of the meeting and there was no concerted effort to address New Century's problematic and recurring loan quality issues.

The Examiner sought to understand why no effective action was taken to address loan quality as a result of the matters discussed on October 25 or even earlier. The Examiner received no satisfactory answer from persons interviewed. The Examiner offers a number of observations about loan quality issues in 2005.

First, Internal Audit, which by October 25, 2005 had delivered to Senior Management several "Unsatisfactory" field audit reports, does not appear to have brought those reports to the attention of the Audit Committee until December 15, 2005.[332] This is perplexing. Zalle, the head of the Internal Audit Department, was present at the October 25 meeting, and it would have seemed natural for him to have mentioned the unsatisfactory Internal Audit field results on October 25, since they were directly relevant to the matters being discussed.

[332] Zalle informed the Examiner that he would meet informally with the Audit Committee chair and that he informed the chair often and in detail of his serious concerns about loan quality. The Audit Committee chair did not recall being so informed.

Second, the lack of priority accorded to loan quality improvement may in part be due to the fact that Flanagan was an extremely powerful force within New Century Senior Management until his departure in December 2005. During Flanagan's tenure, it would have been difficult for persons in Senior Management, even the Company's founders, to make material changes in the operations of the Production Department without Flanagan's agreement. Flanagan apparently resisted significant loan quality improvement efforts that might have affected loan origination volume.

Third, despite the fact that improving loan quality did not get priority attention in 2005, a matter related to loan quality did get attention. By September 2005, New Century Senior Management focused on the fact that its quantity of IO loans had grown to more than 30% of originations. Given continuing deterioration of execution rates in the secondary market, Senior Management reported to the Board in September 2005 that it had established a goal to decrease the quantity of IO products by raising the coupon rates on the product, by adding a 40-year fixed-rate product and by making changes to underwriting guidelines and compensation structures. Senior Management reported that this action was prompted in part by the fact that investors had expressed concerns about IO products in general. This effort proved to be successful, with IO originations dropping to 22.4% of production in the fourth quarter of 2005.

This attention to the risk characteristics of New Century products seems to have been productive. However, as described below, the Examiner believes that New Century should have given greater attention in 2005 and the first half of 2006 to the identification of other particular mortgage loan products that were contributing disproportionately to New Century problems, including rising delinquency rates for Stated Income and 80/20 products. This did not occur prior to the fall of 2006, when New Century's Chief Credit Officer made suggestions to eliminate or cut back on products that contributed disproportionately to risk.

G. Loan Quality in 2006 and Early 2007

New Century's loan quality trends worsened dramatically in 2006 and early 2007. The most important metrics by which New Century tracked loan quality, EPD and kickouts, showed large increases throughout the year. Further, in March and September 2006, it became clear that loans originated by New Century in 2005 and early-2006 had significantly greater delinquency rates than similar loans originated by New Century in 2003 and 2004 and by other subprime lenders in 2006. These trends, coupled with increased investor due diligence, a large increase in

repurchase claims and a focus on the problems identified in the 2005 field audits by the Internal Audit Department, led New Century to concentrate to a much greater degree on improving loan quality.

The increased focus on loan quality began at an Audit Committee meeting in January 2006 and continuing through the rest of 2006 and into early-2007. A loan quality improvement program was initiated in the spring of 2006 and loan quality became a much greater priority than in previous years, particularly after the hiring of a new leader of the Production Department in May 2006 and a new Chief Credit Officer in June 2006.

However, despite these efforts, actual progress in terms of improving loan quality was slow. It was not until summer of 2006 that the new Quality Assurance Department was functioning and that new data became available by which to track by region and personnel the sources of the main loan quality deficiencies. Similarly, it was not until fall of 2006 that significant enhancements to underwriting standards were implemented to cut back on certain loan products that contributed disproportionately to EPD and repurchase claims. Despite greater attention to loan quality matters, the available data showed that even as late as December 2006, the same sorts of problems, including defective appraisals and missing documentation, continued to be the main reasons for investors kicking out increasing quantities of New Century loans.

In short, despite some efforts, New Century failed through most of 2006 to make substantial improvements in loan quality. New Century seems to have finally moved toward making loan quality improvement a priority in the fourth quarter of 2006 and announced at that time that it expected its efforts to result in better quality loans and fewer EPD and repurchase claims in 2007. This was "too little too late." EPD rates did fall in early 2007, dropping from an historic high of 16.82% in December 2006 to approximately 13% in January and February 2007. It appears likely that if New Century had begun determined efforts to address loan quality earlier, the negative trends could have been slowed or reversed earlier, giving New Century a greater chance to survive the crisis that resulted after the February 2007 announcement regarding accounting irregularities.

1. Loan Quality Trends, January 2006 through March 2007

a. Delinquency Data Were Alarming

Three sets of delinquency data, rising EPD, delinquency rates in 2005 originations, and delinquency rates in 2006 originations, all pointed toward New Century's worsening loan quality problems.

First, FPD and EPD rates showed alarming increases over the rates experienced in 2004 and 2005. The following chart illustrates those trends.

Date	FPD	EPD
January 2006	1.18%	8.37%
February 2006	1.67%	8.83%
March 2006	1.57%	7.76%
April 2006	2.00%	12.30%
May 2006	1.67%	10.58%
June 2006	1.98%	11.19%
July 2006	1.94%	12.85%
August 2006	2.08%	13.42%
September 2006	2.05%	14.88%
October 2006	2.29%	12.94%
November 2006	2.26%	14.16%
December 2006	2.58%	16.82%
January 2007	2.20%	13.09%
February 2007	1.99%	13.14%

Second, New Century identified in February 2006 alarming delinquency trends among many of its higher risk 2005 loan originations, demonstrating significantly higher delinquency rates among certain 2005 originations compared to similar originations in 2003 and 2004. Among the trends identified were the following:

> "60+ Delinquency performance has deteriorated in 2005 versus the 2003-2004 vintages. Overall, the 2005 60+ delinquency at month 11 is twice as high as it was in 2003. 80/20 loans show similar trends and although they have higher FICOs, the delinquency is generally higher than the core products, across all vintages.

> Each FICO band was further segregated by Documentation type – either Full Doc or Stated Income. It should come as no surprise the performance of the Stated Income loans is inferior to Full Doc loans. In fact in most instances, the 60+ on the Stated Income loans is 50%-100% higher than the Full Doc across all vintages.
>
> Again we see the very negative performance of the Stated Income/80/20 loans, particularly in the 2005 Vintage. This cohort is at least three times worse than any of the other 2005 Vintage cohorts in the 650+FICO bucket, including the Full Doc/80/20 and Stated Income/Core populations.
>
> We again see terrible performance of the Stated Income\Single\80/20 loans in the 650+ FICO band. The Single Stated Wage Earner loans have by far the highest 60+ while the Single Stated – not Wage earners are at least as high as the Joint Loans."

Therefore, at the beginning of 2006, New Century's Senior Management knew that many of its loan products were performing extremely poorly from a delinquency perspective.

Third, another troubling delinquency trend was identified in September 2006. New Century historically tracked 90+ day delinquency rates of its loans against similar products offered by its competitors. New Century personnel took comfort from the fact that New Century loans from 2003 through 2005 generally had better delinquency rates than the competition. Comparative delinquency rates for loans originated in 2006 did not become available until September 2006 and showed that New Century's 2006 loans had a much higher 90+ day delinquency rate than the competition, with 3.40% of New Century's 2006 loans as of September 2006 showing 90+ day delinquencies compared to 1.08% for the competition. As more comparative data became available in later months of 2006, the quality of New Century loans was shown to continue to trend worse than competitors. The data for October through December for 90+ day delinquencies were as follows:

	Competitors' 90+ Delinquencies	**New Century 90+ Delinquencies**
October	1.70%	4.75%
November	3.39%	5.75%
December	3.39%	5.75%

Cloyd informed the Examiner that these negative trends in New Century's 2006 loans were a significant factor in causing the greater priority on loan quality improvement efforts in the last quarter of 2006.

b. Kickout Rates Continued to Rise in 2006

Kickout rates rose alarmingly in 2006, following the same trend as EPD, far exceeding the five percent acceptable target, even in March 2006 when securitizations were undertaken. The kickout rates were as follows:

Date	Kickout Percentage
January 2006	6.92%
February 2006	6.38%
March 2006[333]	5.67%
April 2006	8.27%
May 2006	7.54%
June 2006	6.61%
July 2006	9.90%
August 2006	9.62%
September 2006	11.48%
October 2006	11.89%
November 2006	12.12%
December 2006	14.95%
January 2007	11.75%

The high kickout rates in 2006 should have been of significant concern to New Century for the same reasons that the 2004 and 2005 rates should have been of concern: the kicked out loans represented more than $5 billion in lost or delayed sales. The same sorts of problems were identified as the chief causes of the kickouts, again indicating that loan quality was inadequate and that the recurring problems in the loan origination processes had not yet been fixed. The trends can be summarized as follows:

Month	**Value of Kickouts**	**Top Reasons for Kickouts**
January	$239,236,818	Property value/appraisals (35.7%) Other (19.01%) Compliance (14.59%)
February	$246,019,179	Appraisals (33.8%) Underwriting (19.52%)

[333] March 2006 had both whole loan sales and a securitization. Overall kickouts were 5.56%; kickouts on whole loan sales alone were 6.80%.

Month	Value of Kickouts	Top Reasons for Kickouts
		Missing Documentation (12.80%)
March	$330,521,451	Appraisals (24.45%) Underwriting (33.94%) Missing Documentation (10.94%)
April	$131,020,752	Appraisals (41.61%) Underwriting (19.40%) Compliance (17.25%)
May	$319,647,911	Appraisals (38.38%) Underwriting (14.53%) Compliance (19.15%)
June	$477,095,992	Appraisals (36.74%) Underwriting (23.72%) Compliance (13.00%)
July	$340,299,202	Appraisals (40.23%) Underwriting (22.33%) Missing Documentation (8.80%)
August	$316,802,423	Appraisals (29.51%) Underwriting (21.79%) Investor Guidelines (10.64%)
September	$978,959,226	Appraisals (38.15%) Underwriting (18.09%) Missing Documentation (10.79%)
October	$612,328,354	Appraisals (25.74%) Underwriting (26.52%) Investor Guidelines (12.53%)
November	$312,949,423	Appraisals (39.63%) Underwriting (19.87%) Missing Documentation (12.52%)
December	$804,631,119	Appraisals (32.14%) Underwriting (25.88%) Investor Guidelines (10.86%)
Total:	**$5,109,511,850**	

In 2006, approximately 13.5%, or $693 million, of the investor rejects were a direct result of missing documentation.

New Century appeared to recognize in January 2006 the importance of reducing the kickout rates. It convened a group of senior managers from the Production, Operations and Secondary Marketing Departments to discuss the so-called "post closing process" to develop means to stem the high and increasing rates of kickouts. However, this was a limited effort and focused only on attempting to make certain that a loan file contained all required documents at the time of funding. It was pointed out that by failing to make sure that loan files were complete, New Century was losing over $20 million annually.[334] Unfortunately, this group was not tasked to address all the other reasons for kickouts. And, as discussed below, the group was not successful in seeking to cure the missing documentation kickouts.

Accordingly, the high kickout rates continued throughout 2006 and into 2007. During this time, New Century managers who communicated the kickout reports to others would point out the types of errors that were repeatedly being found and their frustrations that corrective action had not taken place. For example, in communicating January 2006 kickout data on February 14, 2006, a manager highlighted the following problems with appraisals and compliance issues:

> Appraisal: Month after month a significant amount (over 30%) of our sales fallout is for appraisal issues. For the purposes of focus if we could just cure **the no brainer type items** I list below we would serve ourselves well.
>
> 2nd appraisal on loan amounts over 650K. Per our guidelines we have a second appraisal. If we don't have it we don't sell it.
>
> Appraisal reports need to be complete and signed. If not they are kicked.
>
> Missing 442's. These cannot be waived.
>
> Health and safety issues. Railings on decks and stairwells and evidence of emergency releases on safety bars is an absolute must.
>
> Compliance: We have to do better in MA and TX. Cindy (Nichols that is) what can we do to make this better? I know we are revising the tangible net benefit form which should help in MA.
>
> We just don't seem to do Texas right. Missing disclosures, exceeding 3% fee tolerance, can't reflect benefit to the borrower for discount points charged, etc.
>
> If everyone who produces in these two states can focus a little bit more to make sure we are doing the loans correctly we can increase pull through and profitability.

[334] Based on data available to the Examiner in New Century's monthly Fallout Reports, this number appears grossly underestimated.

> I choose these two areas because **they are black and white**. We are either in compliance or we are not and if we state something in our guidelines we have to do it or we are on the hook for the consequences. Only about 25% or our loans are sampled at the time of sale. That means there are a lot of loans out there with issues that we don't know about. We are in an environment of decreasing if not stagnant value appreciation which means borrowers will be less able to refi for lifestyle finance or to get out of bad situations. When a loan goes bad an investor is going to review that file to see if we did anything incorrectly and if we did they are going to look to use for loss reimbursement. In instances of the items I mention above we are not going to have an argument and there is real potential for this to get expensive. (emphasis added)

The following month, the same manager wrote about the need to improve missing documentation, estimating that fixing the missing documentation problem would reduce 10% of the monthly kickout. The manager stated the following:

> Last month I addressed a couple areas of concern as it relates to appraisal and compliance issues. For this month I would like to focus on missing documentation.
>
> By simply being more thorough in regards to making sure we have all of the necessary documentation in our files we could eliminate 10% of our monthly fallout. This 10% is just the amount we are not able to cure in my world during the due diligence process. I don't have a number as to the amount of missing documentation we do cure but I can tell you that is substantial.
>
> ...
>
> I ask that you please focus on the missing and incomplete documentation going forward. In my mind this is an area ripe for picking in that by taking the time to be thorough we can increase sale execution resulting in more cash in our pocket's [sic] via a more profitable enterprise.

Similarly, in June 2006, a manager wrote the following about May 2006 kickouts:

> Now that I've had a chance to pick myself up off the floor after reviewing the latest investor sale pool results, it is obvious that we have a tremendous amount of work to do. As we have discussed on many occasions, there is no excuse for an investor kick out for missing documentation such as 442s, appraiser explanations, Collateral Analyst supportive commentary, etc. Looking at the condensed report I have furnished for you, it is clear that collateral related kick outs are at an unacceptable level and needs to be fixed. Of course there are some questionable and arguable kick outs for value, distant and/or dissimilar sales, however there are a plethora of rejects that are valid. What is even more disturbing is that the majority of kick outs for collateral had reviews completed by Collateral Analyst and were in markets we have had success with over the past several pool sales.

In yet another communication regarding investor kickouts due to missing documentation, in an e-mail sent to the Chief Credit Officer regarding the August 2006 fallout report, it was

stated that "[m]any of these [loan file documentation] omissions are simply due to sloppy work, trying to get loans closed quickly without being thorough... ."

The Examiner heard through interviews that investors sometimes used kickouts, particularly kickouts based on appraisals which involved a degree of subjectivity, as a means to restructure loan pools in order to purchase only the best-performing loans in the pool. According to a former employee in the Secondary Marketing Department, investors historically would sample of 20 to 30% of the loans in a particular pool as part of their due diligence review. This process changed in 2006 when most investors began to look at the appraisal documents in all loan files of a particular loan pool. Additionally, investors began to examine 30 to 35% of loan files and, in late-2006, one investor conducted due diligence of all of the loan files in a pool. This made it more likely that they would find errors that would give them an excuse to reject loans from a particular pool. Such heightened investor due diligence, especially on appraisal matters, should have provided additional reason for New Century to make it a priority to improve its loan origination processes and loan quality.

c. Internal Audit Continued to Identify Problems with the Loan Origination Processes

The Internal Audit Department in 2006 continued to conduct field audits of New Century's loan origination processes. In the first seven months of 2006, the Internal Audit Department conducted 10 such audits, with nine resulting in "Needs Improvement" ratings and one an "Unsatisfactory" rating. These results, while not as negative as the results from the 2005 field audits, nevertheless documented repeatedly that the same sorts of problems were recurring. For example, in the nine audits where Internal Audit checked to determine if underwriters' approval stipulations had been fully satisfied, it found delinquencies more than 50% of the time in seven of those audits and 27% and 35% of the time in the other two. Similarly, almost every audit determined that name affidavits had been completed incorrectly a high percentage of the time. Such findings were consistent with the types of problems identified by investors when they kicked out loans. Such findings were also consistent with the Internal Audit report to the Audit Committee on January 18, 2006, which indicated that errors related to approval stipulations and name affidavits were the most numerous problems found in the 2005 field audits.

d. The New Quality Assurance Department Identified Problems with the Loan Origination Processes

The reconstituted New Century Quality Assurance Department became active in conducting audits in June 2006. Accordingly, in terms of identifying loan quality trends that perhaps should have prompted earlier steps to make loan quality improvement a priority, the Quality Assurance Department did not play a significant role in 2006. However, once active, the Quality Assurance Department's audit findings confirmed the loan quality concerns that had been identified by others.

For example, in August 2006, the Quality Assurance Department audited 745 loans that had been funded in July 2006. The Department divided its findings into three categories:

Audit function – borrower & property information and program guidelines

Compliance function – legal documents and federal and state regulatory issues

Re-verification – reconfirming the documentation used to determine income and when applicable sufficient funds to close.

With respect to the audit function, any loan that lacked documentation or contained errors in the evaluation of the documentation was rated as high risk if it had a severe impact on loan salability and moderate risk if it had some impact on salability. The results for the August audit showed that 8.05% of the loans were high risk and another 4.03% were moderate risk. The results for the compliance and re-verification functions were similar. The audit function Quality Assurance results for 2006 may be summarized as follows:

Production Month	**High Risk** QA Audit Findings	**Moderate Risk** QA Audit Findings	**Total High/Moderate Risk**
June	1.00%	11.40%	12.40%
July	8.05%	4.03%	12.08%
August	6.62%	3.38%	10.00%
September	7.99%	2.94%	10.93%
October	5.38%	2.22%	7.60%
November	6.29%	3.74%	10.03%
December	5.83%	1.95%	7.78%

2. New Century's Response to the Increasingly Negative 2006 Loan Quality Trends

a. Summary of Loan Quality Improvement Efforts

New Century began to focus on loan quality improvement at the January 18, 2006 Audit Committee meeting. Zalle presented the Committee with a summary of the results of the nine field audits completed by Internal Audit in 2005. The audits for field processing centers found that seven were "Unsatisfactory" and the other two "Need[ed] Improvement." This summary generated considerable discussion within the Committee and between the Committee and Management. The Audit Committee Minutes for January 18 in relevant part read as follows:

> Next, Mr. Zalle responded to specific questions of the Committee regarding the internal audit department's 2005 branch audit results. Mr. Morrice then responded to the Committee's questions about why such a high percentage of the processing centers audited received an unsatisfactory rating and management's response to rectify the problems highlighted by the internal audit department's findings. Mr. Morrice noted that the senior management was focused on improving the Corporation's quality control and quality assurance processes and that the improvement of these processes would, in turn, improve the operations of the processing centers. In response to the Committee's request, Mr. Morrice agreed to provide the committee with reports on the progress of the Corporation's revisions to its quality control and quality assurance programs at the next in-person meeting on March 2.
>
> In response to questions of the Committee, Mr. Zalle noted that the branch audit results had been discussed with senior management and that the internal audit department and senior management had determined that the exceptions noted in the internal audit report were significant. Members of the Committee expressed concern over the number of exceptions noted in the internal audit report and discussed with management ways to improve operations of the processing centers. Mr. Morrice agreed that management would provide an action plan to improve operations of the processing centers at the next in-person Committee meeting on March 2.

This is the first instance found by the Examiner where the Audit Committee appears to have directed New Century Senior Management to develop a loan quality improvement plan. The Examiner sought to determine what factor(s) may have led to this seemingly decisive directive from the Audit Committee. Unfortunately, persons interviewed by the Examiner had poor recollections regarding what led to this change in approach.

Regardless of the precise cause or causes for this changed approach, the January 18 Audit Committee meeting led to sustained, albeit slow, efforts to improve New Century's loan quality. The first steps occurred in February and March 2006:

On February 21, 2006, Zalle distributed a memorandum to Morrice and to Joe Eckroth, recently designated as Chief Operating Officer, outlining a proposed loan quality improvement program.

At the March 17, 2006 Audit Committee meeting, Morrice presented an outline of a "Mortgage Operations – Loan Quality/Compliance Program." Morrice summarized the elements of a loan quality improvement program and identified specific individuals who would be responsible to make sure that the program was implemented.[335] One of the anticipated elements of the improvement plan was to use the compensation system to incentivize loan quality efforts. A PowerPoint presented to the Audit Committee stated "Results and improvements tied to compensation and employment."

Work on the loan improvement program got under way in earnest in mid-April 2006. Significant progress on loan quality improvement efforts was made from May to October 2006. The milestones may be summarized as follows:

On May 1, 2006, Anthony Meola joined New Century as head of Production. Meola was a seasoned mortgage banking professional with big company experience who appears to have had a genuine commitment to improved loan quality. The Audit Committee was advised at its May 12, 2006 meeting that Meola, along with COO Eckroth, would have "ownership" of the loan quality improvement program.

On or about June 1, 2006, Lenice Johnson joined New Century as Chief Credit Officer. Like Meola, Johnson was a seasoned mortgage banking veteran with big company experience and would be responsible, along with others, for a significant revamping of certain underwriting guidelines, starting in October 2006 and continuing into February 2007, which were expected, once fully implemented, to improve loan quality and reduce EPD and repurchase claims.

Relations between Internal Audit and the Production Department were much improved from 2005. In April 2006, Production and Internal Audit personnel agreed to focus on high risk areas to be reviewed by Internal Audit in its field audit program. The Examiner believes that the Internal Audit audit results in 2006 were taken much more seriously by Production than in prior years.

The Quality Assurance function was significantly revamped under new leadership and was operating productively by approximately June 2006.

A new operational risk review program was introduced and in operation by summer 2006. Unlike the Internal Audit and Quality Assurance functions, the operational risk review efforts had personnel reviewing loan files before loans

[335] Joseph Eckroth and various individuals from the Production Department, were identified as having "ownership" of the loan quality improvement effort. As of this time, Senior Management was seeking a replacement for Flanagan. As noted hereafter, once Tony Meola was hired to replace Flanagan as head of Production, Eckroth and Meola were identified as the "owners" of this project.

were funded and thus had the ability real time to make a difference in the quality of loans.[336]

The Company expanded its anti-fraud software (FraudMark), which it had been using as a predictive analytic tool, to allow the software to conduct a "real-time" fraud analysis of in-process loan files. FraudMark then automatically referred certain loans to risk managers if the loans appeared to be problematic. The Company reported that from March until September 2006, FraudMark helped identify and prevent funding of over $630 million in risky loans.

By August 2006, New Century had developed enhanced data, known as the Scorecard and Dashboard reports, which allowed New Century personnel to identify particular New Century employees and brokers with whom New Century was doing business that were contributing disproportionately to loan quality problems. Mr. Meola and others made a practice of meeting regularly with Production managers at monthly Loan Quality Scorecard Steering Committee meetings to review these reports and to encourage managers to take action in light of the data that were developed. The first such meeting was August 28, 2006.[337]

In October 2006, New Century announced changes designed to tighten underwriting standards, with the expectation that over time, such changes would bring down the EPD rates and repurchase claims. In an October 12 press release, New Century stated, among other things:

> "Tightening underwriting guidelines for its adjustable-rate mortgage programs for at-risk borrowers. This includes using the fully-indexed rate minus 1 percent as the qualifying rate for these borrowers.
>
> Offering existing adjustable-rate mortgage (ARM) and interest only customers who qualify for the option of refinancing into a low fee 30-year or 40-year fixed-rate mortgage. . . .
>
> . . .

---

[336] An operational risk group had been under consideration for more than a year. Thus, on March 3, 2005, Zalle had advised the Audit Committee as follows:

> Internal Audit is currently consulting with the EVP/COO of Production Operations in establishing an "Operations Audit" organization within Wholesale and Retail to conduct compliance and control "self-assessments." Assuming this new organization is approved, significant reliance can be placed on day-to-day audit monitoring by Operations nationwide.

This program to improve loan quality was not implemented, however, until Summer 2006, when New Century adopted a program that had been started initially at RBC Mortgage, the loan origination platform that was acquired by New Century in September 2005. This is an example of a loan quality improvement effort that presumably could have been initiated far earlier than it was.

[337] This is another instance of Senior Management taking an action in 2006 that could have been taken much earlier. As noted, the Audit Committee was told on October 25, 2005 that the Credit Department had developed a means to identify underwriters whose actions led to a high number of defective loans. Senior Management did not implement that effort.

Enhancing its processes for confirming the income information provided on stated income loans."

In sum, between January 2006 and the fall of 2006, considerable loan quality improvement projects were identified and steps to implement the efforts were carried out.

b. Limitations to the Loan Quality Improvement Efforts

New Century's 2006 loan quality improvement program, however, did not have a high priority through virtually all of that year. Loan quality improvement was discussed frequently and certain concrete steps were taken in support of the efforts. However, the progress was slow and there was internal resistance.

First, while the Audit Committee insisted in January 2006 that the loan quality improvement effort be undertaken, the Committee failed to follow up to ensure that the effort was a top priority. As noted, the effort did not get under way in a meaningful fashion until April 2006. The Audit Committee received briefings on the efforts at the May 12 and July 26, 2006 meetings, but there was no detailed follow up and no timetable was set for getting improvements in place. For example, the minutes of the July 26 meeting reflect that one director requested that Senior Management "provide the Committee with a specific report on precisely what impact compliance with the [loan quality improvement] plan would have on an employee's compensation and Morrice agreed to provide such a report." The Examiner found no evidence that any such report ever was provided. Similarly, at the same meeting, the Audit Committee was told that Johnson, the new Chief Credit Officer, would have a role "in revising the Corporation's underwriting policies as a result of the implementation of the plan" and would be introduced to the Committee at its next meeting. Johnson never attended an Audit Committee meeting.

After the July 2006 meeting, the Audit Committee devoted little attention to loan quality until the end of the year. There was brief discussion of the loan quality improvement efforts at the October 30, 2006 Audit Committee meeting, but the minutes indicate that Senior Management advised the Committee that a more detailed report would be provided at the December meeting. There appears to have been no objection to deferral of the issue until December.

Accordingly, at least in terms of the Audit Committee, the full implementation of the loan quality improvement plan does not seem to have been a priority. No timetable was set and no results were demanded. It is thus not surprising that progress was not reported in 2006. When

the Audit Committee met in December 2006, the New Century loan quality trends were mostly unchanged from the beginning of the year. The minutes from the December 12, 2006 Audit Committee meeting reflect that there was "[a] lengthy discussion . . . about the Corporation's increase in first payment defaults, early payment defaults and investor kickout rates and the actions Management was taking to reduce these trends."

Second, the Examiner learned in his investigation that notwithstanding efforts to get the loan quality improvement plan implemented, it was not an easy task to get persons to support the need for serious changes. For example, for a long period of time, New Century's Production Department had been extraordinarily successful in originating loans. Accordingly, there was resistance to efforts by some persons to change the culture of New Century in fundamental ways. Meola said that he needed to speak repeatedly with Production Department personnel to get them to buy into the need for Production personnel to focus on loan quality. Meola also reported to the Examiner that some Production veterans sought Morrice's help to reduce his emphasis on improving loan quality. Meola explained, therefore, that this was something that simply took more time than anticipated, but he also stressed that by late 2006 and early 2007, he believed that progress was taking place. For example, the Examiner reviewed an e-mail chain from December 2006 in which one of Meola's direct reports, a long-time Production Department veteran, contacted a large number of his subordinates about the importance of preventing fraud in the loan origination process. Meola forwarded the e-mail to persons who had been working on the loan quality improvement effort, commenting: "We are slowly changing the mind set. [____'s] note below is an excellent example."

A related, difficult task was the effort to tie loan quality to compensation within the Production Department. Meola described his efforts over many months to persuade senior members of the Production Department to make loan quality a high priority and then to agree to tie loan quality improvement to compensation in a meaningful way.

It appears that progress in this regard did take place, but it again took significant time. At the start of 2007, New Century put in place controls designed to incentivize account executives in the Production Department to focus on loan quality. New Century introduced the "broker scorecard" system whereby brokers who had an excessive quantity of loans that had FPD would be separated from their account executive and the account executive would not be able to earn income from loans submitted by that broker. In addition, the broker might be suspended from

providing loans to New Century. Meola explained that he felt this system, when fully implemented, would provide a significant financial incentive to account executives since they depended on broker relationships for their compensation. If they were faced with losing such broker relationships, they would have a greater incentive to develop relations only with brokers who tended to present high quality loans.

Third, the Examiner found evidence that there was some internal resistance to some of the efforts to improve New Century's underwriting guidelines, even in the face of mounting EPD and repurchase claims. New Century's new Chief Credit Officer and her staff analyzed EPD and repurchase claims to identify products that disproportionately were responsible for such claims. She then proposed in October 2006 to New Century's Business Unit Review Department certain changes, such as to tighten standards for loans to first time home buyers. She developed data that demonstrated that first time home buyers with stated wage earner loans (i.e., loans where the borrower did not need to demonstrate past income sufficient to afford the loan) represented three percent of originations but 7.1% of EPD. She proposed to eliminate such loans, especially since most of New Century's competitors had already eliminated this product. She recalled that Morrice was initially quite reluctant to agree to the changes. Johnson believed the reluctance reflected a desire to keep New Century's origination volumes as high as possible. Eventually, virtually all of the changes that were proposed were implemented, but the initial resistance meant that many of the changes did not take effect until December 2006 and February 2007, too late to have any meaningful impact.

By late 2006, New Century's Senior Management appeared to believe that enhanced underwriting standards would lead to better loan quality and reduced repurchase claims. For example, in the PowerPoint that accompanied New Century's third quarter earnings release in November 2006, New Century stated:

> We anticipate FPD and loan repurchases will stabilize, then decline, as underwriting changes take full effect.
>
> . . .
>
> Improved underwriting guidelines expected to enhance future loan performance.

New Century also implemented credit changes that effectively tightened underwriting guidelines in December 2006, stating that these changes "will reduce the occurrences of credit losses and exposure to delinquency performance."

Fourth, it is troubling that New Century did little in 2006 to address the high rates of kickouts, particularly on the process issues such as loan files that lacked required documentation. As previously noted, the fallout reports month after month and year after year reported the same sorts of problems resulting in kicked out loans. Indeed, it is ironic, as reported above, that 2006 began with a Post Closing Group being convened to address the high rate of kickouts, and the year closed in the same way. In a December 20, 2006 presentation entitled "Post Closing Process Review," Management identified yet again the need to improve its processes, stating the mission as follows:

> Review current Post-Closing operational process to identify causes for missing files and documents. Recommend policy, process, technology, organization and other applicable enhancement opportunities to minimize the cost of exceptions and improve the efficiency and quality of service.

These process issues fundamental to the quality origination of subprime mortgage loans should have been addressed earlier and with greater priority by New Century's Senior Management and Board.

In 2006, missing documents remained a significant reason for kickouts, with the estimated dollar amounts of loans not purchased due to missing documentation being as follows:

January	$ 38,417,079
February	$ 40,022,174
March	$ 44,148,263
April	$ 13,657,097
May	$ 38,153,243
June	$ 62,533,882
July	$ 43,619,723
August	$ 38,934,857
September	$ 142,980,831
October	$ 74,767,085
November	$ 51,599,504
December	$ 103,684,840
	$ 692,518,578

Interviewees advised the Examiner that kickouts due to missing documentation should have been relatively easy to fix. New Century apparently devoted little or no effort to fixing this problem and instead allowed high kickout rates for missing documentation to continue throughout 2006.

It is also noteworthy that problems with appraisals remained a significant concern throughout 2006, just as they were a significant problem throughout 2004 and 2005. Even though appraisals emerged as the number one reason for kickouts throughout most of 2006, New

Century did not act on this information in any meaningful way. For example, a September 7, 2006 e-mail from the head of the Operational Risk Department suggested that New Century needed to create a working group to "drill down on the high kick out appraisal value issues, with the goal to identify root causes." Further, even as late as December 2006, the Audit Committee minutes reflected that Senior Management advised the Committee that "deficiencies in the appraisal process were a significant contributing factor to the unfavorable trends" in EPD and kickouts. Indeed, even in January 2007, New Century still had not squarely addressed the appraisal issue. For example, Meola noted in an e-mail that "our appraisal policies are stale, [and] we need to address them next and expeditiously" and in another e-mail stated "we have been asking for 5 months, when can we attack appraisals and how?" Cloyd responded to this e-mail, stating "we'll put it on the pile with everything else..."

During 2006, New Century also experienced kickouts related to underwriting deficiencies. A reason for some of those kickouts is that New Century made exceptions to underwriting guidelines in many of the loans it originated, with maximum loan amount, LTV and DTI exceptions being the most common. Notwithstanding the frequency of exceptions, New Century had no formal exceptions policy. A former New Century Chief Credit Officer stated that she fought to have a formal exceptions policy but that it was hard to get anything implemented because of the inefficiencies of Senior Management. She added that the Credit Committee eventually created a standard exceptions policy, but she understood that the policy was rescinded after she left the Company in early-2006. The Examiner found no evidence of such a policy.

Another former New Century Chief Credit Officer said she was surprised when she joined New Century in 2006 that decisions to make exceptions were managed by persons in the Production Department and not the Credit Department. She found this unusual as, in her experience, companies made exceptions either through the Chief Credit Officer or through a formal exceptions matrix.

In short, 2006 was a mixed year in terms of loan quality improvement efforts. Undeniably, New Century made progress on loan quality improvement in 2006, instituting new programs and tightening underwriting standards. However, with regard to basic loan origination processes, New Century made little effort and the Examiner could discern no tangible progress or improvement in that area. Rather, as noted above, kickouts trended upwards throughout the

year and even relatively easy to fix defects, such as documentation missing from files, remained a significant problem.

H. Concluding Loan Quality Observations

The Examiner concludes that New Century's Board of Directors and Senior Management failed for many years to give loan quality the attention that it deserved. Loans originated by New Century were critical to New Century's financial success. Loans that were carefully processed, with all underwriting requirements satisfied, were more likely to be purchased at premium prices in the secondary market, and the borrowers on such loans were generally more likely to meet payment obligations, thus avoiding EPD and ensuring a constant stream of interest income to the owners of such loans.

New Century knew from multiple data sources that its loan quality was problematic, starting no later than 2004. Yet, as documented in this portion of the Final Report, the Board of Directors and Senior Management before 2006 took few steps to address the troubling loan quality trends. Such inaction cost New Century millions of dollars in lost revenues, including from loans that it could not sell at a premium in a timely manner, from loans that needed to be repurchased after borrowers defaulted, and from the numerous loan kickouts that were experienced month after month.

The Examiner believes that the Board could have paid closer attention to loan quality issues during much of 2004 through 2007. However, the Examiner recognizes that the Board is entitled to rely on Senior Management to run the day-to-day affairs of the Company. Further, the Board, through the Audit Committee, periodically did give some attention to loan quality issues, such as at Audit Committee meetings in 2004 (June and August) and 2005 (October and December, albeit briefly). In 2006, the Audit Committee gave rather extensive attention to loan quality issues, with the issue discussed at meetings in January, March, May, July, October and December. In such instances, particularly in 2006, Senior Management repeatedly assured the Board that New Century's loan quality problems were being addressed. The Examiner concludes that the Board were likely entitled to rely upon such assurances.

The Examiner is much more critical of Senior Management, particularly with respect to its failure to address kickouts, including problems that reportedly would have been relatively simple to correct, such as missing documentation from loan files. This was a fundamental error: no loan should have been funded if the paperwork was incomplete or missing. The Examiner

was told repeatedly in his investigation and confirmed through the review of many documents that kickouts were an important metric of loan quality. The fact that New Century meticulously analyzed the reasons for kickouts on a monthly basis serves to underscore the importance of this metric.

The Examiner received no satisfactory reasons to explain why the loan quality issues that caused so many kickouts were not addressed proactively. No interviewee suggested that it would have been too hard or too expensive to correct the problems leading to kickouts. To the contrary, the Examiner heard over and over again that while some number of kickouts was inevitable, the kickout rates incurred by New Century were far too high and should have been reduced. In short, the Examiner believes that Senior Management may have abdicated its responsibility to manage the Company's day-to-day affairs by failing for so long to make reduction of kickouts a priority. As a result, New Century lost millions, possibly hundreds of millions, of dollars in revenues.

The Examiner is also critical of Senior Management for failing to address sooner the increased riskiness of some of the loan products New Century was originating. With few exceptions, such as the cutback on the IO product in September 2005, Senior Management was informed about the increasing risks associated with some its products but took few timely actions to seek to address or mitigate those risks. New Century finally began to address the products that contributed disproportionately to EPD and repurchase claims, but by then, billions of dollars of unsound mortgages were either held by New Century or sold in the market.

VI. ACCOUNTING ISSUES

A. Repurchase Reserves

1. Executive Summary

On February 7, 2007, New Century announced that it needed to restate its earnings for the first nine months of 2006 due to its failure to account properly for the loan repurchase loss reserve required to be established under GAAP for probable expenses and losses to be incurred on loans that New Century had sold but then potentially was obligated to repurchase ("repurchase reserve"). New Century subsequently announced on May 24, 2007 that it was more likely than not that similar accounting errors made New Century's 2005 financial statements unreliable.

The magnitude of such accounting errors was significant. The Examiner estimates that at year-end 2005, the repurchase reserve should have been approximately $17.0 million, rather than the $5.5 million reported by New Century in its 2005 Form 10-K.[338] Similarly, at September 30, 2006, the repurchase reserve should have been approximately $115.2 million, rather than the $10.3 million reported by New Century in its Form 10-Q for that quarter.[339] In addition, as part of its reserve calculation, New Century failed to account properly for losses on loans that it had already repurchased, so-called Inventory Severity. These errors in the reserve calculation amounted to approximately $9.8 million at year-end 2005 and $85.8 million at September 30, 2006, with these incorrect amounts ultimately affecting New Century's LOCOM valuation adjustment to loans held for sale, rather than the repurchase reserve itself.

New Century entered into sales agreements with loan purchasers ("Investors"), selling most loans at a premium to par value. In 2005, on average, New Century appears to have sold loans at a 2.06% premium to par, meaning that a $100,000 loan, on average, was sold for $102,060. In such sales agreements, New Century typically was obligated to repurchase a loan from Investors if the borrower defaulted on the loan soon after the sale or if New Century failed to comply with representations and warranties contained in the loan purchase agreements.

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[338] The actual amount of repurchase reserve reported in the 2005 Form 10-K was $6.955 million, of which $5.5 million related to New Century Mortgage Corporation and the remainder related to Home 123. The data in this section of the Report pertain only to New Century Mortgage Corporation.

[339] The actual amount of the repurchase reserves reported in the third quarter of 2006 Form 10-Q was $13.885 million, of which $10.3 million related to New Century Mortgage Corporation.

When New Century repurchased loans, it incurred expenses and potential losses. First, New Century not only needed to pay the Investors then-existing full principal amount of the loan, but also was required to repay the Investors the premium (or some portion of it) that had been paid at the time of the original sale ("Premium Recapture"). Second, New Century had to pay Investors for any interest due on the loan that had not been paid by the borrower ("Interest Recapture"). Third, New Century needed to account for any losses on the loan that it repurchased. Repurchased loans frequently were not performing as required, such as due to a continuing borrower payment default, and the loan might be worth substantially less than the full principal amount at which it was repurchased by New Century.

Under GAAP, New Century was obligated to establish a loss reserve for potential expenses and losses related to repurchases that could be expected. In its Form 10-K for 2005, and for earlier periods as well, New Century stated that its repurchase reserve was "the Company's estimate of the total losses expected to occur" in connection with the potential loan repurchase exposure related to loan sales.[340]

There is no dispute that New Century failed to account properly for repurchase reserves. New Century admitted on February 7, 2007 and May 24, 2007, and the Examiner's investigation has confirmed, that New Century violated GAAP in multiple respects. KPMG, New Century's independent auditor, similarly has acknowledged that New Century did not satisfy GAAP requirements pertaining to repurchase reserves and repurchased loan valuation.

First, for all accounting periods up to the third quarter of 2006, New Century failed to include amounts in the repurchase reserve for Interest Recapture. Second, starting in the second quarter of 2006, New Century failed in its repurchase reserve calculation to compute the LOCOM adjustment ("Inventory Severity") for loans that it had already repurchased but had not sold. Third, starting in the third quarter of 2006, New Century failed to reserve for anticipated losses on loans that would need to be repurchased in the future ("Future Loss Severity"). Fourth, New Century in 2005 and 2006 greatly underestimated the quantity of loans that would need to be repurchased because it assumed that only loans sold within 90 days of the close of a quarterly accounting period would be subject to possible repurchase, thus failing to reserve for a large and growing backlog of repurchase claims relating to loans sold before that 90-day period ("Backlog Claims").

[340] Form 10-K for 2005 at F-16.

The Examiner investigated to determine how these material errors came about over such a long period of time and whether there was any purposeful failure to calculate the repurchase reserve and LOCOM correctly, such as to increase earnings. The Examiner found no persuasive evidence of such a motivation, even though New Century's second and third quarter 2006 changes to its repurchase reserve calculations had the effect of increasing earnings. For example, the second quarter of 2006 elimination of Inventory Severity in the LOCOM valuation account increased earnings by approximately $23.4 million in that quarter and the elimination of Future Loss Severity in the third quarter of 2006 increased earnings that quarter by approximately $28.1 million.

At a minimum, these errors were due to New Century's and KPMG's failure over an extended period to devote the necessary professional attention to making certain that the repurchase reserve and LOCOM were calculated correctly. There is little evidence that either New Century or KPMG personnel ever looked critically at the reserve calculation methodology, including the LOCOM portion, to assess whether it was being done correctly. This continued in 2005 and 2006, even when a large increase in repurchase claims underscored that the repurchase reserve and its associated method of calculation were extremely important. Accordingly, when KPMG suggested possible changes to the repurchase reserve calculation in 2006, the changes were implemented by New Century with little careful attention to GAAP requirements by either New Century or KPMG personnel.

Neither New Century nor KPMG took responsibility for initiating changes to the accounting pertaining to the repurchase reserve calculation. For example, there is no dispute that the elimination of Inventory Severity in the second quarter of 2006 was an error. Personnel from the Accounting Department, however, point to KPMG as having recommended this change. KPMG personnel on the other hand, acknowledge raising the issue but not recommending the change.

The Examiner concludes that there is joint responsibility for the repurchase reserve calculation errors. KPMG was at the center of the repurchase reserve calculation changes and the LOCOM calculation, and almost certainly first suggested the second quarter of 2006 accounting change and advised that the changes made in the third quarter of 2006 were appropriate. At the same time, New Century's Accounting Department personnel had a responsibility independently to review professional standards and to make determinations as to

the propriety of accounting changes. The data suggest that New Century personnel spent little time in serious professional consideration of the changes, opting instead to implement changes that served to reduce the repurchase reserve (or the rate of increase in that reserve) and the LOCOM valuation account at a time when New Century's repurchase claims were reaching historic levels.

Similarly, New Century and KPMG each share responsibility for failing to correct the repurchase reserve calculation methodology that permitted the Backlog Claims to be excluded from the repurchase reserve through all accounting periods. The data are clear that New Century personnel knew that many repurchase claims pending as of the time of a quarterly financial statement pertained to loans that had been sold in earlier quarters. KPMG likely knew of this information in early 2005, and data specifically communicated to KPMG in early 2006 that pending repurchase claims were $188 million at December 31, 2005 should have made KPMG investigate the issue. Both New Century and KPMG, however, proceeded quarter after quarter to assume with no in-depth investigation that the only loans needing to be considered in the repurchase reserve calculation were loans sold during that quarter. This was a significant error, accounting for more than 50% of the dollar value of the repurchase reserve accounting errors.

The conduct of New Century and KPMG personnel is all the more surprising because members of the Audit Committee regularly questioned Accounting personnel and KPMG auditors, particularly in 2006, to seek assurance that New Century had adequate repurchase reserves. For example, at the July 26, 2006 Audit Committee meeting, KPMG reported to the Committee on its review of New Century's financials for the second quarter of 2006, which is precisely when the Inventory Severity change in repurchase reserve calculation methodology was discussed between KPMG and New Century. The minutes of that meeting make clear that the repurchase reserve was an important topic:

> Mr. Kim reported that KPMG was in the process of reviewing the Corporation's second quarter financial information and that its review was primarily focused on the accounting for the Corporation's derivatives, allowance for loan losses, repurchase reserves and residual interests. Mr. Sachs then asked a question about the adequacy of the Corporation's repurchase reserves and Mr. Donovan [KPMG] and Ms. Dodge responded. (emphasis supplied)

Neither New Century Accounting personnel nor KPMG at that meeting, or any time thereafter, disclosed to the Committee that the repurchase reserve calculation methodology had been changed in a manner that would increase earnings in the second quarter of 2006 by $23.4

million. Rather, the consistent answer at this and other Audit Committee meetings was that the reserve was more than adequate and that New Century might even be over-reserved.

Moreover, despite its identification in 2005 of New Century's lack of a formal policy with respect to its repurchase reserve as a control deficiency, KPMG never detected that New Century failed to take into account the backlog of repurchase claims in its reserve calculation. KPMG further failed to detect that New Century had not taken interest recapture into account until the third quarter of 2006, and failed to determine that its repurchase reserve process was not compliant with FAS 140.

Finally, the failure to take a more critical look at the repurchase reserve calculation methodology is all the more inexplicable because the New Century repurchase reserve presented a red flag, as New Century reserved significantly less than smaller mortgage banking companies. Within a month the Taj Bindra started as New Century's CFO in November 2006, he asked New Century's Accounting personnel, and later KPMG, to justify the amounts and calculation methods for New Century's repurchase reserve. Such inquiries by Bindra led in relatively short order to the discovery of material accounting errors in January 2007 and the restatement announcement on February 7, 2007. This is further evidence that both New Century personnel and KPMG may have engaged in conduct that failed to meet applicable standards.

2. The Applicable Accounting Standards

a. Statements of Financial Accounting Standard ("FAS") 5 and 140

FAS 140 requires a transferor of loan assets, such as New Century, to recognize all assets obtained and liabilities incurred upon completion of a transfer of financial assets, such as mortgage loans, that qualifies as a sale. One such liability consists of the expenses and losses estimated to be incurred in connection with the repurchase of loans previously sold. The repurchase reserve is the quantification of that estimated liability.

Paragraph 55 of FAS 140 states: "The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date."[341] This means that the transferor must record, as part of the

[341] The "change" referenced in FAS 140 relates to the circumstances under which a transferor, in this case New Century, would be required to regain control of loans previously sold.

loss estimate, any amounts that are expected to be paid to the purchaser over the fair value of the repurchased loan at the repurchase date.

Under FAS 140, a repurchase reserve is calculated at the time of sale at fair value as part of the computation of gain or loss on the transfer of assets. Subsequent calculation of the repurchase reserve is based on FAS 5, *Accounting for Contingencies* ("FAS 5"). Under FAS 5, a liability for a loss contingency, such as an early payment default, is recorded on the transferor's balance sheet if it is deemed to be probable and can be reasonably estimated. The "probable" condition for recording a liability is provided in FAS 5 as follows:

> Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

For New Century, there was no question at the time a pool of loans was sold that a certain number of such loans would need to be repurchased. Based on historical experience, New Century knew that some borrowers would default shortly after the loans were sold and that Investors would require New Century to repurchase some of those loans. New Century also knew from experience that even aside from early payment defaults, it would doubtless receive some repurchase claims arising out of allegations that loans sold failed to comply with typical representations and warranties contained in loan sale agreements. Similarly, the requirement that the loss contingency be reasonably estimable was never in dispute because the sorts of expected expenses and losses, such as Premium Recapture, could be reasonably estimated. Thus, under FAS 5, the "probable" and "estimable" conditions were satisfied and New Century at every quarter calculated a repurchase reserve.

For repurchase reserves on sold loans, two categories of loss contingencies subject to FAS 5 should have been identified. The first category was known claims existing as of the date of the New Century quarterly financial statements. In other words, when a transferor like New Century received notification of repurchase claims but had not yet repurchased the loans associated with those claims, it had to estimate and reserve for the potential losses that might be incurred on those claims. In this Final Report, the Examiner has divided this first category of repurchase claims into two groups. The first group is repurchase claims reported to New Century pertaining to loans that were sold in the same quarter as the financial period for which a repurchase reserve needed to be calculated ("Reported Current Claims"). Thus, if New Century

was seeking to calculate its repurchase reserve for the first quarter of 2006, the Reported Current Claims would be repurchase claims reported to New Century pertaining to loans sold to investors in the period January 1 through March 31, 2006. The second group is reported repurchase claims pertaining to loans sold to investors prior to the quarter the report is being filed. In the above example, reported repurchase claims pertaining to loans sold prior to January 1, 2006, such as loans sold in the fourth quarter of 2005 and before, fall into this second group and are referred to as "Backlog Claims."

The second category of loss contingencies is potential claims that had not yet been reported as of the quarterly financial statement closing date. For example, New Century knew, as of the date that it filed a Form 10-K or Form 10-Q, based on historical data, that some repurchase claims would arise for loans sold that quarter, but New Century had not yet received notification of these claims as of the date of the financial statements. Because it was known that some of these as-yet-unreported claims would result in repurchase obligations, an estimate and reserve for the related potential expenses and losses were required. These are referred to as "Future Current Claims," as they were assumed to be claims relating to loans sold in the same current financial reporting period but would be received in the future.

The data set forth later in this section of this Final Report establish that New Century did not include in the repurchase reserve calculation any estimate of expenses and losses associated with Backlog Claims. Rather, New Century developed a repurchase reserve calculation methodology that was intended to cover the Reported Current Claims and Future Current Claims (collectively, "Current Claims"), but the methodology omitted during all reporting periods Backlog Claims. This was a significant error, leading to a material underestimation of the quantity of repurchases for which the repurchase reserve needed to account.

b. The Components of New Century's Repurchase Reserve

There are three GAAP-required components of a repurchase reserve: Premium Recapture; Interest Recapture; and Future Loss Severity. Additionally, loans repurchased from investors are required to be valued at LOCOM and reported in a valuation allowance account related to loans held for sale. Each of these four components is described below.

i. Premium Recapture

As noted, New Century generally sold its mortgage loans to investors at a premium, i.e., at a price exceeding their par value. Under the loan purchase agreements, when a repurchase

was made, New Century was required to repay the investors the premium (or some portion of it) paid in the original loan sale transaction. New Century estimated the premium that it would have to repay as the average premium paid by investors on loans sold, multiplied by the estimated volume of loans that would need to be repurchased from loan sales in the prior three months. The Premium Recapture calculation may be illustrated as follows:

Prior three months loan sales:	$1,000,000
Estimated repurchase percentage rate:	1%
Average premium:	2%
Premium recapture:	$1 million times 1% times 2% = $200

New Century consistently included Premium Recapture in its repurchase reserve calculation for all time periods reviewed by the Examiner.

ii. Interest Recapture

New Century also agreed in its loan purchase agreements to pay investors any lost interest on loans that New Century repurchased. Accordingly, if a borrower defaulted on loan payments and one or more interest payments had not been paid to the investors, New Century was required as part of the repurchase to pay the investors the lost interest. Interest Recapture was calculated by determining the weighted average coupon (*i.e.*, interest rate) of the loans originated during that three-month period, multiplied by the assumed missing interest payments (generally three payments) and the repurchase rate. The Interest Recapture calculation may be illustrated as follows:

Prior three-month loan sales:	$1,000,000
Estimated repurchase percentage rate:	1%
Average coupon interest rate:	10%
Assumed annualized missing interest	$1,000
Estimated Interest Recapture:	($1,000 divided by 12 times 3) = $250

Historically, New Century did not include Interest Recapture in its repurchase reserve calculation. New Century included Interest Recapture for the first time in the third quarter of 2006, based at least in part on the erroneous opinion of KPMG that the repurchase reserve should be based solely on Interest and Premium Recapture. The Examiner did not undertake a detailed review to quantify the dollar amounts of Interest Recapture that should have been included in the repurchase reserve for reporting periods before year end 2005. However, the Examiner estimates

that the unreported Interest Recapture component of the repurchase reserve for 2004 should have been approximately $790,000, compared to the reported repurchase reserve in the 2004 Form 10-K of $7.9 million, an understatement of about nine percent.

iii. Future Loss Severity

Under GAAP, New Century was required to estimate the losses on loans that would need to be repurchased in the future. This amount, referred to in this Final Report as Future Loss Severity, was to be calculated on the basis of an estimate of the difference between the actual repurchase price that was estimated to be paid and the estimated fair value of the future repurchased loan on the date of repurchase. A repurchased loan often had an impaired market value. Apart from the repurchase obligation expenses outlined above, an additional loss could be expected when the repurchased loan, with whatever defects that triggered the repurchase, was eventually repurchased. Future Loss Severity was calculated by New Century based on the prior three months whole loan sales, the historical repurchase percentage rate and the historical percentage of repurchased loans actually sold at a loss, the result of which was multiplied by the average historical loss incurred on sales of repurchased loans. The calculation of Future Loss Severity may be illustrated as follows:

Prior three months loan sales:	$1,000,000
Estimated repurchase percentage rate:	1%
Historical % of repurchased loans repurchased at a loss:	50%
Historical loss rate on repurchased loans:	20%
Estimated Loss:	$1 million times 1% times 50% times 20% = $1,000

As set forth later in this Final Report, New Century removed Future Loss Severity from the repurchase reserve calculation in the third quarter of 2006.

iv. Inventory Severity

Inventory Severity represented the LOCOM adjustment related to repurchased loans held on the Company's balance sheet pending resale. This LOCOM adjustment was calculated by New Century as part of its repurchase reserve calculation, which is why the Examiner is reporting on Inventory Severity (LOCOM) in this portion of the Final Report. In fact, however,

Inventory Severity or LOCOM is not a part of the repurchase reserve but instead is a valuation allowance account related to loans held for sale ("LHFS").

Loans repurchased by New Century frequently had severe defects, meaning that they likely would be resold at a loss, *i.e.*, at a price well under par value. New Century was required to recognize losses on such LHFS, which was the difference between the carrying value of such loans and their fair value. As discussed hereafter, New Century stopped accounting for Inventory Severity on repurchased loans in the second quarter of 2006, which resulted in a material overstatement of the value of LHFS in the second and third quarters of 2006. In addition, New Century misapplied LOCOM on loans for which a valuation allowance had been established, which resulted in an overstatement of the value of LHFS in the fourth quarter of 2005 and the first quarter of 2006.

3. The Calculation of the Repurchase Reserve at New Century

The Examiner sets forth in the discussion that follows in roughly chronological order the development of the New Century repurchase reserve calculation methodology, the changes to it over time, and the role of KPMG auditors related to that calculation methodology.

a. Development of the Repurchase Reserve Calculation Methodology Prior to 2006

i. Initial development of the repurchase reserve calculation methodology up to 2005

New Century initially developed its methodology for calculating the repurchase reserve in the 1990s. Dodge was New Century's Controller at the time and informed the Examiner that she developed the initial methodology. According to Dodge, the first step in calculating the reserve was to determine an estimated loan repurchase rate for the financial statement reporting period in question. She did this by comparing the historical number of loans repurchased with the number of historical loans sold. Initially, the repurchase rate was calculated using industry-wide repurchase data. New Century later began to use its own historical repurchase data for the calculation when New Century's loan sale volume grew to be significant.

Once the repurchase rate was estimated, Dodge estimated the number of whole loan sales at risk of repurchase by reviewing data provided by New Century's Secondary Marketing Department. Dodge explained that repurchase claims were typically made within approximately 90 days of the loan sale. Accordingly, Dodge believed that a 90-day look-back period for loans at risk of repurchase provided a reasonable estimate of that exposure. Accordingly, it was the

practice of New Century in determining the volume of loans that might be subject to repurchase claims to look only at the volume of loans sold in the 90 days prior to the close of the reporting period. For example, if the reporting date was as of the end of the first quarter, *i.e.*, March 31, the 90-day look-back would mean that loans sold from January 1 through March 31 would be the universe of loans to which to apply the estimated repurchase rate.

Dodge informed the Examiner that she also would consider loans sold outside the 90-day look-back period if she had reason to believe that they might give rise to a repurchase claim. Dodge informed the Examiner that she was unsure whether the persons who subsequently took over calculation of the repurchase reserve, Walker and then Kenneally, continued to look at loans outside the 90-day look-back period.[342] The Examiner concludes that they did not. Indeed, the New Century Form 10-K for 2005, when addressing the repurchase reserve, makes clear that New Century used only the 90-day look-back window to estimate the volume of loans that might be at risk for repurchase. Thus, that Form 10-K stated:

> Approximately $10.7 billion and $8.3 billion of loans were subject to repurchase, representing loans sold during the fourth quarter of 2005 and the fourth quarter of 2004, respectively.[343]

Indeed, Sanchez recalled raising with Kenneally the issue of looking at loans sold more than 90 days earlier for purposes of the repurchase reserve calculation and was informed that New Century was contractually obligated to repurchase loans only within 90 days of the sales.

Dodge explained that once she had determined the volume of loans that might be subject to repurchase claims and the estimated repurchase rate, she then applied the repurchase rate to the number of whole loan sales at risk to come up with the amount of loans likely to be repurchased by the Company. The next step was to determine the average dollar amount of Premium Recapture that would need to be returned to the investors on the repurchased loans.

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[342] In or around 1999, Dodge delegated the calculation of the quarterly repurchase reserve to Walker and trained her on the procedure. Walker continued to take the lead on calculating the repurchase reserve until 2003, when Kenneally was hired as New Century's Controller and Dodge assigned the repurchase reserve calculation role to him. Kenneally calculated the repurchase reserve using the methodology and formula he inherited from Dodge and Walker. Kenneally regarded this as essentially a mathematical formula that was not even necessary for him to perform personally. After 2003, Kenneally delegated the calculation of the reserve to Trevor Drummond, and it later became Theresa Lam's responsibility. At one point, Tony Sanchez also got this assignment. All of these individuals reported to Kenneally, who informed the Examiner that the method of calculating the repurchase reserve remained unchanged from 2003 until the second quarter of 2006.

[343] Form 10-K for 2005 at 65.

She determined the average premium and then multiplied this rate by the amount of loans likely to be repurchased to determine the Premium Recapture component of the repurchase reserve.

The next estimate involved calculation of Future Loss Severity and Inventory Severity. Dodge again used historical data to determine both the percentage of repurchased loans likely to be sold at a loss and the average loss rate. The result of this calculation yielded the severity components for losses on repurchased loans and on loans likely to be repurchased. Finally, Dodge added the Premium Recapture component to the Future Loss Severity component to arrive at the repurchase reserve amount. The Inventory Severity component of the reserve calculation would then be transferred to the LHFS valuation allowance account as part of the LOCOM adjustment.

The failure to include Interest Recapture in the repurchase reserve calculation from the outset is perplexing because the Examiner understands that it was a long time requirement under loan purchase agreements for New Century to pay to Investors the amount of interest that the borrower had failed to pay. Accordingly, this was a standard part of a repurchase arrangement, no different in substance than the Premium Recapture that was included at all times in the calculation of the repurchase reserve.

The Examiner also sought to determine how KPMG failed to question why New Century did not include Interest Recapture in the repurchase reserve calculation in 2005 and in earlier years. The loss severity factor that New Century used in its repurchase reserve calculation was based on historic loss rates on repurchased loans that were subsequently resold. This calculation did not take into consideration any Interest Recapture because it was based solely on the difference between the principal balance of the repurchased loan and the ultimate loss incurred upon resale of that loan. Therefore, New Century was not factoring into the loss severity factor any Interest Recapture it would have to pay to Investors upon repurchasing a loan.

The KPMG repurchase reserve conclusion memorandum for the year end December 31, 2005 stated with no supporting documentation that Future Loss Severity included Interest Recapture. However, the Examiner has reviewed the elements used by New Century to compute the loss severity factors and has determined the loss severity factors did not include Interest Recapture.

The Examiner was informed that KPMG was told during the 2005 audit by Kenneally that Interest Recapture was included in the New Century repurchase reserve calculation. Further,

a KPMG workpaper from January 2006 notes that estimated losses on future repurchases "include[s] accrued interest the investor would have collected from the borrower, if the loan had performed, that New Century must pay to the investor at the time of repurchase." If KPMG had performed adequate tests and calculations, it would have determined that Interest Recapture was omitted from the repurchase reserve calculation.

ii. New Century and KPMG's attention to the repurchase reserve in 2005

The failure of New Century to include Backlog Claims in the repurchase reserve constituted by far the greatest reason that the repurchase reserve was understated at December 31, 2005. The Examiner investigated to determine if there were any particular developments in 2005 that might have suggested an awareness on the part of New Century or KPMG that the repurchase reserve calculation had flaws and/or needed to be reexamined. The Examiner identified data that make clear that the proper calculation of the repurchase reserve, including the Backlog Claims issue, should have been an issue for both New Century and KPMG in 2005.

First, on January 26, 2005, as part of its 2004 audit of New Century's financial statements, KPMG specifically asked New Century's Accounting Department via e-mail (Walker with a copy to Kenneally) why there had been a "big jump" in repurchases in November 2004. This provoked an e-mail exchange within New Century, culminating with the following explanation from Cloyd to Walker: "many of the loans repurchased were from prior quarters and months leading to the increased volume and discount." This is a clear indication that New Century Accounting Department personnel knew that many loans that were ultimately repurchased in 2004 were Backlog Claims, *i.e.*, or loans sold outside the 90-day window that New Century used to calculate the volume of loans that might need to be repurchased. Notwithstanding this information, New Century did nothing to adjust its methodology for estimating the quantity of loans that might need to be repurchased as of the end of a financial reporting period. Rather, in its 2004 Form 10-K filed March 1, 2005, New Century reported that only loans sold in the fourth quarter of 2004 were at risk of repurchase.[344] New Century did nothing to determine how many Backlog Claims it had pertaining to loans sold prior to the fourth quarter of 2004.

[344] Form 10-K for 2004 at 76.

KPMG probably also knew of this information since KPMG had initiated the request for such data. The Examiner determined that Walker planned to forward Cloyd's e-mail to her KPMG counterpart but appears never to have done so. However, the Examiner believes that KPMG was likely apprised of this information. KPMG, like New Century, did nothing to investigate. Thus, a KPMG memorandum as part of its 2004 year-end audit states:

> At 12/31/04, KPMG notes that the Company assumed that only the most recent 3 months of sales are at risk of repurchase.
>
> . . . .
>
> Based on the review of the Company's repurchase log and discussions with management, it appears reasonable that the most recent 3 months sales are at risk for repurchase.

The Examiner cannot accept the explanation that KPMG got comfort from having reviewed the New Century repurchase log. The repurchase log identified loans that New Century repurchased from 2001 onward. The log identified the date that New Century originally sold the loan and the date that New Century had repurchased the loan but did not set forth when the repurchase claim was received by New Century. If KPMG had indeed undertaken a careful review of that log, it would have recognized, consistent with the Cloyd communication mentioned above, that many loans that had been repurchased by New Century in the fourth quarter of 2004 were Backlog Claims relating to loans sold more than 90 days prior to being repurchased.

Second, a KPMG auditor, Christina Chinn, recalled being present at a meeting in the second half of 2005 with Kim and Kenneally where Kim raised issues related to the components of the repurchase reserve calculation and questioned whether it was appropriate to account for Future Loss Severity in the calculation. The issue was not resolved at this meeting, and Chinn did not recall either Kim or Kenneally taking a strong position either way. The Examiner believes that the fact that KPMG was questioning whether New Century was correctly calculating the repurchase reserve should have triggered action by KPMG and/or New Century to take a hard look at the calculation methodology, particularly since, as reported below, the level of repurchase claims increased in 2005, with the reported 2005 repurchase rate being almost double that of 2004.

However, through 2005, repurchases were not the focus of special interest at New Century, at least for most persons. Karl Weiss, Senior Vice President, Capital Markets, informed the Examiner that neither New Century's Investors, nor anyone in Management, paid special attention to repurchases until the middle of 2006 or later that year. Flanagan, head of New Century's Production Department, similarly told the Examiner that he believed New Century received few repurchase claims through 2005.

Robert Lent, the Vice President of Secondary Marketing who had responsibility for managing repurchase claims, had a different view. He detected signs of a trend toward increased repurchase claims in 2005. According to Lent, the level of repurchases started to increase in mid-2005 as a result of an increase in early payment defaults. Indeed, as reported in the Loan Quality portion of this Final Report (particularly Section V.), EPDs increased steadily from mid-2004 onward and the dollar amount of repurchases increased sharply in the second quarter of 2005 from under $25 million in the first quarter of 2005 to around $100 million per quarter for the remainder of 2005.

Third, new data became available in early 2006 that should have prompted New Century and KPMG to be concerned about potential Backlog Claims. On February 9, 2006, Christina Chinn, who was working on testing the adequacy of the New Century repurchase reserve, asked New Century for data about pending repurchase claims as of December 31, 2005. Lent responded via e-mail on February 10:

> We had outstanding repurchase requests of $188mm at year end. The majority of which, $157mm, were for early payment defaults.

This communication should have been a significant red flag for New Century (and KPMG) that the 90-day look-back assumption might lead to a serious underestimation of likely repurchases for which a reserve was required. Assuming that Lent's data were correct (and KPMG so assumed), this meant that New Century as of December 31, 2005 had repurchase claims that represented approximately 1.8% of fourth quarter of 2005 loan sales (those sales were approximately $10.7 billion). Assuming a 20-25% success rate in refuting repurchase claims (roughly New Century's historical rate), this still meant that New Century could anticipate repurchases of around 1.4% of fourth quarter of 2005 loan sales, a rate much higher than the repurchase rate experienced for several years.

These data should have put New Century and KPMG on the alert for the possibility that the $188 million in repurchase claims reflected a certain amount of Backlog Claims. At a minimum, it should have prompted some detailed analysis by KPMG whether this suggested a new trend of significantly higher repurchase claims that could affect assumptions in the methodology for calculating the repurchase reserve. This did not happen. Indeed, a KPMG auditor advised the Examiner that KPMG did not take the $188 million in claims into account in calculating New Century's repurchase reserve for the fourth quarter of 2005.

KPMG's substantive procedures for its 2005 audit involved consideration of the Risk of Significant Misstatement ("RoSM") at the significant account and disclosure level "because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level." RoSM requires consideration of both the inherent risk and the control risk associated with the repurchase reserve calculation. KPMG reported that it regarded the RoSM with respect to New Century's repurchase reserve calculation as "moderate" in 2005 and determined that the controls in place at the time were "effective." The level of RoSM assessed by KPMG dictated the nature, timing, and extent of substantive audit procedures to be performed (e.g., tests of details, third-party confirmations, substantive analytical procedures, etc.). "The higher [our] assessment of the risk of significant misstatement the more persuasive the audit evidence we obtain from substantive procedures."

KPMG was aware that New Century had experienced significantly higher repurchases in 2005 than 2004 and that its pending claims were high as well at year end 2005. Thus, as noted previously, KPMG was informed that New Century had $188 million in pending repurchase claims as of December 31, 2005. Further KPMG's workpapers from January 2006 demonstrate KPMG's knowledge that New Century had spent $332.1 million in 2005 on repurchases, compared to $135.4 million in 2004. Such data clearly should have alerted KPMG to an ominous trend in repurchases and should have triggered inquiry into whether New Century was adequately reserved for repurchase claims. However, no such inquiry took place. Rather, KPMG's audit procedures[345] in connection with the 2005 audit of the repurchase reserve were limited to re-performing and validating underlying data pertaining to the calculation of the repurchase reserve and analytically reviewing those data.

[345] Audit procedures included KPMG's tests of controls as well as their analytical and substantive testing. The Examiner has focused on the analytical and substantive testing for the repurchase reserve since these procedures were also employed during the quarterly reviews.

The KPMG conclusion memorandum pertaining to the New Century repurchase reserve for the 2005 audit summarized its procedures to roll forward the repurchase reserve account balance for the fourth quarter of 2005 and to test the mathematical accuracy of the Company's worksheet for calculation of the repurchase reserve. In this connection, KPMG reviewed and annotated the various components used to calculate the repurchase reserve and documented its understanding of factors used to calculate the repurchase reserve. The memorandum was prepared by Chinn and initialed by Debbie Biddle and Mark Kim. It sets forth, among other things, the following:

- YTD 2005 loan repurchases had more than doubled, from the 2004 figure of $135.4 million to $332.1 million
- As of the time of the audit, there were $188 million in outstanding repurchase requests, of which $157 million were first payment defaults.

KPMG concluded that the "methodology estimates and data used in determining the Company's reserve for future repurchases and expected losses [and] the amount reserved...appear reasonable."

The Examiner concludes that KPMG must be faulted for its handling of this information. For the fourth quarter of 2005, New Century calculated based on historic averages from 2001 onward that the repurchase percentage would be 0.659%. Then, using whole loan sales from the fourth quarter of 2005 ($10.715 billion), New Century determined that $70.648 million of those sales would likely need to be repurchased. KPMG accepted these figures. In the process, however, New Century and KPMG ignored the documented fact that there were $188 million in actual pending repurchase claims at December 31, 2005. Assuming that New Century could refute about 25% of those claims, this meant that approximately $141 million in loan sales pending as of December 31, 2005 would need to be repurchased — more than double the $70.648 million calculated by New Century and accepted by KPMG. The large difference between these numbers should have prompted both New Century and KPMG, at a minimum, to inquire whether the repurchase reserve calculation methodology needed to be reexamined. This did not happen.

KPMG did not document in any detail its bases for its conclusion that New Century's 2005 repurchase reserves were reasonable. For example, a note in the KPMG workpapers relating to "Historic Loss Rate on Discounted Loan Sales" states:

> Historic loss rate on discounted loan sales (since January 1, 2003) as calculated by the Company, [was] 13.38% at 12/31/05 appears reasonable as it is fairly consistent with [the prior quarter]. In addition, losses experienced on discounted sales during Q4 is 13.42%, the loss rate utilized in the reserve appears consistent with actual losses experienced.

The Examiner's investigation did not reveal any information suggesting that KMPG questioned New Century about the adequacy of this historic loss rate to cover future period liabilities. Similarly, there is no evidence that KPMG questioned New Century with regard to the repurchase percentage of 0.659% despite being informed of the $188 million of pending repurchase claims at December 31, 2005. The Examiner received no explanation as to how KPMG could have satisfied its professional responsibilities without probing such data.

In addition, in its SOX review for 2005, KPMG identified New Century's failure to adopt a formal policy for estimating the repurchase reserve as a control deficiency. KPMG's 2004 SOX review had similarly determined that New Century lacked formal documentation setting forth its repurchase reserve estimation process. KPMG observed in its 2005 SOX audit that New Century had failed to take steps to remedy the 2004 problem in 2005.

In November 2005, Trevor Drummond of New Century prepared a memorandum to the Accounting File regarding the Allowance for Repurchase Losses, which set forth a description of New Century's repurchase accounting processes. In December 2005, KPMG reviewed the memorandum and initially took the position that the memorandum did not remediate the deficiency of a lack of formal policies and procedures, noting that the memorandum was in draft form and not finalized. However, one day later, and without further explanation, KPMG decided that the draft memorandum satisfied the required remediation and the issue was "cleared" without exception. The Examiner cannot understand how KPMG could so conclude since the memorandum is most noteworthy for its generalities and its failure to set forth any of the required elements of the repurchase reserve calculation. The memorandum, in full, is as follows:

> Generally Accepted Accounting Principles ("GAAP') for recognition of loan losses is provided by Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies ("SFAS No. 5')". An estimated loss from a loss contingency, such as the potential repurchase of loans, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated. Additional guidance on the recognition, measurement, and disclosure of loan losses is provided by Emerging Issues Task Force ("EITF') Topic No. D-

80, Application of SFAS No. 5 and No. 114 to a Loan Portfolio (EITF Topic D-80), Financial Accounting Standards Board Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss ("FIN 14")"and the American Institute of Certified Public Accountants (AICPA) "Audit and Accounting Guide, Banks and Savings Institutions".

General

The allowance for repurchase losses on loans sold relates to expenses incurred due to the potential repurchase of loans or indemnification of losses based on alleged violations of representations and warranties which are customary to the mortgage banking industry. Generally, repurchases are required within 90 days from the date the loans are sold. Occasionally, New Century Financial Corporation ("the Company") may repurchase loans after 90 days have elapsed. In connection with its allowance for repurchase losses on loans sold, the Company establishes an allowance for loan losses based on its estimate of losses inherent and probable as of the balance sheet date. The Company evaluates the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans, credit characteristics of the portfolio, the underlying value of the collateral and the general economic environment. Using historic experience and taking into consideration the factors, above, the Company estimates an allowance for repurchase losses, which it believes is adequate for known and inherent losses. Provisions for losses are charged to gain on sale of loans and credited to the allowance while actual losses are charged to the allowance.

Accounting

The accounting for the repurchase reserve, if necessary, is recorded upon the completion of analysis with current quarter's repurchase reserve balance. To aide with the analysis, historical data is used as a guide to assist in evaluating a recommended balance, per FIN 14. Also, documented analysis from Secondary is used as a reference when reviewing the repurchase reserve balance per quarter. If an adjustment is required, the appropriate management review will be obtained and the transaction will be recorded onto the financial statements.

b. Repurchase Reserves in the First Quarter of 2006

In the first quarter of 2006, New Century continued to use its existing methodology to calculate the repurchase reserve. A historical repurchase rate was calculated by dividing New Century's total repurchases from the beginning of 2001 through the end of 2005 by New Century's total whole loan sales over the same period. This calculation resulted in an estimated repurchase rate of 0.689% for the first quarter of 2006. New Century then applied this percentage to the first quarter of 2006 whole loan sales to estimate the dollar amount of loans New Century was likely to repurchase. The Examiner found no evidence that New Century or

KPMG in preparing or evaluating the first quarter of 2006 repurchase reserve focused on the reported $188 million in outstanding repurchase claims that existed at year-end 2005 or the number of pending claims as of March 31, 2006 as part of determining the quantity of loans that might be repurchased. New Century then determined the Future Loss Severity and Premium Recapture components of the reserve calculation by applying these rates to the volume of loans estimated to be repurchased, resulting in New Century's total repurchase reserve for the first quarter of 2006 in the amount of $6.916 million.

For the period ended March 31, 2006, New Century prepared a standard worksheet entitled "Analysis of Adequacy of Repurchase Reserve," which KPMG reviewed as it did in all reporting periods. The workpaper documented KPMG's review, bearing the initials of several KPMG auditors, including Donovan, Kim and Chinn. The worksheet includes, among other things, the following entries:

- Estimated Potential Future Repurchases $80.5 million
- Estimated Potential Repurchases with Losses $44.4 million

A comparison of these figures with those from the first quarter of 2005 reveals that the estimated potential future repurchases had more than doubled, from $29.7 million to $80.5 million. Estimated potential repurchases with losses more than doubled, from $18.9 million to $44.4 million. The Examiner found no evidence that this substantial increase resulted in more than a routine inquiry into whether the repurchase reserve was correctly calculated.

c. The New Century Repurchase Reserve in the Second Quarter of 2006

In the second quarter of 2006, New Century repurchase claims continued to rise. According to a New Century "Repurchase Activity" slide presentation dated September 2006, which was circulated widely, including to senior members of the Accounting Department, repurchase claims as a percentage of production volume nearly tripled in the first half of 2006 compared to 2005 levels.[346] This same presentation estimated that as of July 2006, $150 million in repurchase claims were outstanding and that 30% of the $150 million ($45 million) were from 2005, thus putting the New Century Accounting group directly on notice that New Century had significant Backlog Claims and that the 90-day look-back resulted in New Century ignoring such

[346] From 0.57% of 2005 production volume to 1.62% year-to-date July 2006 production volume.

Backlog Claims. This is the quarter in which the repurchase reserve calculation methodology began to be modified.

First, New Century's practice was to calculate its estimated repurchase percentage rates based on historical rates going back to 2001. However, in the second quarter of 2006, as repurchase claims continued to rise and the market was shifting in a negative direction, New Century decided that the estimated repurchase percentage rate should reflect more current trends. As a consequence, the Accounting Department modified the historical time period for calculating the estimated repurchase percentage to the beginning of 2004 (instead of 2001) through the second quarter of 2006. Kenneally advised the Examiner that he believed that this change would make the repurchase reserve calculation more sensitive to then-current economic conditions. This change resulted in a new estimated repurchase rate of 1.0% for the second quarter of 2006, compared to the 0.689% rate used in the first quarter of 2006.

Second, the Accounting Department eliminated Inventory Severity from the repurchase reserve calculation. As noted, Inventory Severity was an amount intended to estimate the future losses to be incurred on loans that had already been repurchased. Inventory Severity had been consistently a component of the repurchase reserve calculations in prior financial reporting periods and then would be reclassified on the balance sheet into a LOCOM valuation allowance account and reported as a contra-asset to LHFS. However, according to New Century's repurchase reserve analysis worksheet for the second quarter of 2006, the Inventory Severity component was removed in the second quarter of 2006 from the calculation because the amount was believed "appropriately [to be] considered in [the Company's] LOCOM [lower of cost or market] analysis." This turned out to be an error, as discussed in the LOCOM discussion.

The Examiner investigated to determine how Inventory Severity came to be eliminated from the repurchase reserve calculation in the second quarter of 2006, with no notice thereof to the Audit Committee or most members of Senior Management, aside from Dodge who likely knew of the change. The precise sequence of events is not clear. However, from all the data, the Examiner concludes that this accounting change reflects a combination of a suggestion from Kim of KPMG that such a change was consistent with GAAP and a subsequent decision by the Accounting Department, after a review of accounting literature, to effectuate the change. There was no notification made by the Accounting Department or KPMG to the Audit Committee,

which was at this very time seeking assurance that New Century's reserves were adequate. The approximate sequence of events is as follows.

Kenneally recalled that this change occurred as a result of a suggestion from Kim. Kenneally said the proposed change in the methodology was first mentioned in mid-July 2006, when Kenneally was focused on closing the second quarter books. Kim initially proposed the change at a meeting with Sanchez, who reported on the meeting to Kenneally. According to Kenneally, Kim informed Sanchez that New Century might be double-counting and over-reserving this category of loss. When New Century repurchased loans, it held those loans on its balance sheet at their par value pending sale. When New Century performed its LOCOM analysis, it would offset the mark-to-market losses from these repurchased loans by other loans held for sale that had market values in excess of cost, thus not realizing any loss for repurchased loans. However, until the second quarter of 2006, a separate mark-to-market calculation was made for the repurchased loans as part of the repurchase reserve calculation and the amount was reclassified to a contra-asset account against LHFS. Since the loans had been marked to market as part of the LOCOM analysis, Kim informed Sanchez that New Century did not need to record the loss related to these loans. Kenneally and KPMG now recognize that this view was incorrect under relevant accounting principles and the Company's application of GAAP with respect to LOCOM, which still required a mark to market calculation for Inventory Severity for the loans repurchased.

Kenneally recalled that after he had heard this KPMG suggestion, he and Sanchez reviewed accounting literature and concluded it made sense. Kenneally acknowledged that an added benefit of this change to the calculation was a credit to the income statement in an amount he later estimated to be approximately $21 million.

Sanchez's recollection of events was similar to Kenneally's. He recalled discussing issues related to the repurchase reserve calculation with Kim in connection with quarter-ending work related to the second quarter of 2006. According to Sanchez, Kim explained how New Century needed to include Interest Recapture in its repurchase reserve calculation but should not include Future Loss Severity or Inventory Severity in the calculation. Sanchez mentioned this conversation in an e-mail to Kenneally and Walker dated July 28, 2006: "[r]epurchase reserve [was] called into question by Mark Kim, BUT I was somewhat successful after a root canal meeting...He agrees that our new way is better...." (emphasis in original). According to

Sanchez, this conversation with Kim in July 2006 was when Sanchez was first introduced to the possibility of changes to the methodology for calculating the repurchase reserve.[347] However, at his interview with the Examiner, Sanchez did not recall Kim discussing the issue of double-counting the loss as a result of the LOCOM calculation. Also, while Sanchez recalled that Kim had suggested in or around July 2006 that Interest Recapture needed to be added to the repurchase reserve calculation, that was not done in the second quarter of 2006 and no other interviewee recalled the mention of Interest Recapture at that time. The Examiner cannot reach a final determination whether Interest Recapture was discussed in the second quarter of 2006 timeframe.

Walker became aware of the change to the reserve calculation in the second quarter of 2006 because it affected the work she performed to prepare the Form 10-Q. Walker said she recalled speaking to Kenneally about this while he was simultaneously speaking to Dodge on the phone. According to Walker, Kenneally told her and Dodge that it was no longer necessary to include repurchased loans in the reserve because this amounted to "double-counting" or "double-dipping." Walker recalled Kenneally saying he "had a conversation with KPMG" or "ran it by KPMG," and that KPMG agreed with the change to the calculation. She remembered that Kenneally said he discussed this with Kim.

The Examiner investigated these communications in several interviews with Kim, who had inconsistent recollections of what he did and knew at various times. Kim told the Examiner that he was not aware that New Century removed Inventory Severity from the repurchase reserve calculation in the second quarter of 2006 and did not recommend it. However, these statements must be viewed together with the fact that Kim did recall having a conversation with Kenneally in the second quarter of 2006 about whether the severity adjustments to the repurchase reserve calculation would result in a potential double-counting given the Company's LOCOM analysis.

Kim initially told the Examiner that he did not know about the second quarter Inventory Severity change until the year-end 2006 audit. However, Kim acknowledged that he discussed the removal of Inventory Severity from the reserve calculation with Kenneally, but he was not sure that the discussions took place in the second quarter. He said he believed Kenneally was going to do his own research on the issue and the Company would formulate its own position.

[347] Sanchez's recollection is not precise as to the time of this and other conversations with Kim, which he says may have occurred at earlier dates and involved the issues of the three-month look-back period and the inclusion of interest in the reserve calculation.

Moreover, a number of KPMG workpapers contradict Kim's recollection that he had no contemporaneous knowledge of the second quarter of 2006 change to the repurchase reserve calculation methodology. For example, Kim's initials appear on an analysis of the repurchase reserve calculation, which specifically notes that the "Mark To Market on Repurchases Not Yet Sold" (*i.e.*, Inventory Severity) was not applicable because it was "appropriately considered in the LOCOM analysis." Kim stated that he did not remember whether he noticed the change had been made when he initialed the papers on August 7, 2006.

Additionally, Chinn prepared a "Balance Sheet Analytics" workpaper, also approved by Kim, for the period ending June 30, 2006, which directly addressed the discontinued use of Inventory Severity, using the following language:

> The decrease in this account from both March 31, 2006 and June 30, 2005 is due to discontinued use. This account was used by the Company as a valuation allowance to mark certain loans repurchased not yet sold. However, in the current quarter the Company has discontinued use of this account as these repurchased loans are properly included in the LOCOM analysis of loans held for sale.

Kim's handwritten revisions to this paragraph in a prior version of this Balance Sheet Analytics workpaper appear verbatim in this final version. Kim acknowledged that the comments were his, but nonetheless insisted that that he did not recall making them or having discussed the change in calculation methodology with anyone.

The Examiner concludes that KPMG knew of the elimination of Inventory Severity and that Kim almost certainly provided advice in connection with the second quarter of 2006 financial statements concerning the elimination of Inventory Severity from the repurchase reserve calculation. The Examiner also concludes that New Century personnel did not simply rely on this KPMG suggestion but also sought to review accounting literature to some extent to confirm that the change was appropriate. The Examiner is aware of no effort by KPMG to assess through a review of accounting literature whether such a change would be appropriate.

In connection with the second quarter of 2006 financial statements, KPMG did not prepare a specific repurchase reserve conclusion memorandum to accompany its workpapers.[348] KPMG workpapers indicate that KPMG tested the mathematical accuracy of the New Century second quarter of 2006 reserve computation. There is no indication that KPMG questioned the

[348] It was KPMG's practice to prepare conclusion memoranda on some significant accounting issues in its year-end audits and on some Forms 10-Q.

applicability of the use of historic repurchase rates, the exclusion of potential Backlog Claims from the repurchase reserve calculation, the elimination of Inventory Severity, or the lack of accounting for Interest Recapture.

The Examiner is further troubled by the handling of the second quarter of 2006 change to the calculation methodology because this matter was not disclosed to the Audit Committee. The Audit Committee met on July 26, 2006 and repurchase reserves were a specific topic of discussion. The minutes indicate that "Mr. Sachs then asked a question about the adequacy of the Corporation's repurchase reserves and Mr. Donovan [KPMG] and Ms. Dodge [New Century] responded." Neither Donovan nor Dodge disclosed the changes, although Kenneally advised the Examiner that he assumed that the changes had been discussed since repurchase reserves were on the agenda for that meeting. [349]

d. Repurchase Reserves in the Third Quarter of 2006

i. New Century makes additional changes to the calculation of the repurchase reserve

New Century made further changes in the third quarter of 2006 to its methodology for calculating the repurchase reserve, raising the repurchase rate percentage, eliminating Future Loss Severity and adding Interest Recapture to the calculation. The Examiner describes these changes below.

First, New Century raised the estimated repurchase percentage rate from the one percent in the second quarter of 2006 to 1.75% in the third quarter of 2006. The increased repurchase percentage was the product of discussions among the Secondary Marketing, Accounting and Finance Departments, and grew out of a recognition that the historical calculation no longer reflected the current market environment.[350] Kenneally later believed that the estimate of 1.75% used in the third quarter of 2006 may have been low and observed that a rate of 2.75% was intended to be used in the fourth quarter of 2006 forecast.

Second, Kenneally informed the Examiner that he excluded Future Loss Severity from the repurchase reserve calculation in the third quarter of 2006 because KPMG recommended that the reserve should only consist of an estimate of Interest and Premium Recaptures. Kenneally

[349] Kenneally was not present at this Audit Committee meeting because he was attending a conference out of town.

[350] The 1.75% figure was based on an expected repurchase claims rate of 2-2.25% and the assumption that 20-25% of such claims would be successfully refuted. Kenneally stated that the increase from one percent to 1.75% in the third quarter of 2006 was in direct response to a larger number of repurchase claims in June 2006, and was done in consultation with Dodge and Cloyd.

told the Examiner that Kim initially proposed this change to the methodology to Sanchez. Kenneally told the Examiner that the purpose of the removal of Future Loss Severity in the third quarter was to implement fully what he and Sanchez had started, at Kim's suggestion, in the second quarter of 2006. Sanchez told the Examiner that Kim told him that the Company should not include the loss on future repurchases, but that Kim did not explain this. According to Sanchez, Kim and Kenneally had a separate meeting, following his own meeting with Kim, that he did not attend. Sanchez told the Examiner that Kenneally said to him, in late September or early October, that he had spoken to Kim and would consider whether to change the reserve calculation.

Kim acknowledged that Future Loss Severity had been removed from the repurchase reserve calculation in the third quarter of 2006. He told the Examiner that his recollection of what occurred in the third quarter of 2006 was limited to knowledge that: (i) interest to be refunded to investors had been added to the reserve calculation; (ii) that New Century had changed the historical experience methodology; and (iii) that losses on future repurchases were not being included in the calculation.

There is also contemporaneous documentary evidence of KPMG's and Kim's knowledge of the removal of Future Loss Severity in KPMG's quarterly review of documents produced by the Company each quarter entitled, "New Century Mortgage Corporation Analysis of Adequacy of Repurchase Reserves," dated March 31, June 30 and September 30, 2006. In these quarterly documents, there are itemized dollar amounts for Future Loss Severity for the first two quarters of 2006, referred to as Estimated Potential Repurchases with Losses. That entry was removed in the third quarter, however, and the entry for Estimated Losses on Future Repurchases was comprised solely of the estimated Interest and Premium Recapture. KPMG is linked to contemporaneous knowledge of this change not only by virtue of the fact that Kim reviewed and initialed these documents, but also because Kim advised New Century that the change documented in these workpapers, *i.e.*, the substitution of interest and premium costs for Future Loss Severity, was appropriate.

Specifically, Kim admitted to the Examiner that he had advised Sanchez only that Premium and Interest Recapture should be reserved and not Future Loss Severity. He told the Examiner this conclusion was justified by equating the sum of estimated Premium Recapture and estimated Interest Recapture to Future Loss Severity – as set forth in the third quarter analysis

document Kim initialed. Kim also conceded that even if he once held this belief, he did not do so any longer. He explained that he abandoned this belief when he learned of paragraph 55 of FAS 140 in the early part of 2007.

Kim told the Examiner that he advised Sanchez in September 2006 that there was no accounting literature applicable to the issue of calculating the repurchase reserve. Kim admitted that when he so advised Sanchez, he did not know that paragraph 55 of FAS 140 applied to repurchase reserve calculations. Indeed, according to Kim, he was not even aware of paragraph 55 of FAS 140 until January 2007, when he was copied on an e-mail from Donovan to Kenneally discussing it. In that e-mail, Donovan sought to explain in simple terms the concept of severity with respect to repurchases. Citing paragraph 55 of FAS 140, the e-mail stated:

> When you repurchase the loan it needs to come back at fair value. In the example yesterday, if you repurchase the loan for 104, and you determine for whatever reason the loan is only worth 90 then you have to record the loan at 90. 14 would be debited to the reserve and 90 is the new cost basis for the loan when you put in loans held for sale.

Walker recalled that when the issue of the potential accounting errors came to her attention in January 2007, Kenneally forwarded her this e-mail with the reference to paragraph 55 of FAS 140. Walker experienced a "mouth-dropping" moment when she read the e-mail and realized severity had been eliminated from the reserve calculation. In Walker's opinion, paragraph 55 of FAS 140 required, among other things, that potential repurchase liability be reserved for — and because severity is the loss contingency on repurchases that has to be reserved for — the removal of the severity components from the reserve calculation did "not make sense to [her] at all."

Dodge did not remember specifically when she first learned about the repurchase reserve calculation methodology changes, although she believes she would have known about the changes by November 2006 when Kenneally made a presentation to the Audit Committee on the LOCOM analysis. Morrice told the Examiner, however, that Dodge said that Kenneally told her about the changes when they occurred and that KPMG had approved them. Kenneally also told the Examiner that he briefly discussed the methodology change with Dodge, explained that the suggestion was made by KPMG, and that Kenneally and Sanchez had reviewed the literature and that KPMG's position made sense.

These third quarter of 2006 changes to the repurchase reserve calculation methodology were not revealed to the Audit Committee despite many opportunities for KPMG and Management to do so. In the fourth quarter of 2006, there were four meetings of the Audit Committee attended by Kenneally, Kim and Donovan. According to the minutes of these meetings, a report to the Committee from KPMG was always the first item on the agenda. At the October 25 meeting, Donovan advised the Committee that "management's estimates with respect to its repurchase reserves were considered adequate when compared to historical experience." At other meetings, Donovan and Kim reported to the Committee on the adequacy of internal controls over financial reporting and the lack of material concerns with respect to Management's preparation of financial information. Despite these repeated and ample opportunities for Accounting and KPMG to apprise the Audit Committee of the significant modifications to the repurchase reserve calculation which had occurred in the prior two quarters, neither disclosed this information to the Committee

ii. KPMG's analysis of the adequacy of the repurchase reserve in the third quarter of 2006

For the quarter ended September 30, 2006, KPMG analyzed the adequacy of New Century's repurchase reserve. A New Century worksheet was prepared by Theresa Lam and approved by Sanchez. Kim initialed the analysis.

The New Century worksheet estimated potential future repurchases in the amount of $242 million (more than double the prior quarter's $101 million). Because New Century did not include any severity component in the third quarter of 2006 repurchase reserve calculation, the component estimating potential repurchases with losses was eliminated. The estimated losses on future repurchases included only Interest and Premium Recapture. The actual repurchase reserve amount in the third quarter of 2006 as reported in the New Century Form 10-Q was $10.373 million, which was $1.681 million less than the reserve of $12.054 million for the second quarter of 2006, despite a tremendous increase in repurchase claims in 2006. If Future Loss Severity had remained in the repurchase reserve in the third quarter of 2006, and if it had been calculated consistent with the method employed in the second quarter of 2006, the reserve calculation would have been approximately $28.1 million greater than reported.

Unlike the first and second quarters of 2006, KPMG completed a repurchase reserve conclusion memorandum for the third quarter of 2006. The procedures identified in this memorandum were: (i) "Analyze [New Century's] accounting change given current accounting

literature to decide the proper accounting and disclosure requirements"; and (ii) "Analyze the method of calculating the repurchase reserve for reasonableness."

The memorandum included an analysis of two changes made in the third quarter repurchase reserve calculation. First, it documented that New Century increased the rate at which loans were expected to be repurchased to 1.75%, to account for changes in the operating environment, but did not document any testing on whether such an increase was adequate.

Second, the memorandum documented the addition of Interest Recapture as part of the reserve. It indicated that the component known as Estimated Losses on Future Repurchases previously included Future Loss Severity, but was now comprised solely of Premium and Interest Recapture. The memo stated that the reason for the change was that the "former method was essentially an adjustment that is accounted for in the Company's LOCOM adjustment."

KPMG concluded that the changes constituted a change in accounting estimate, and not a change in accounting principle in accordance with FAS 154, *Accounting for Changes and Error Corrections*. Finally, the KPMG memorandum concluded that "[t]he calculation appears appropriate as a method of estimating the Company's repurchase reserve liability." The KPMG memorandum reflected no evidence that KPMG undertook any careful review of these changes in calculation methodology by New Century. Similarly, the Examiner's interviews with KPMG personnel established that KPMG merely discussed such changes but undertook no rigorous review to assess whether the changes complied with GAAP or relevant accounting literature, such as FAS 140.

iii. The growing backlog of repurchase claims should have caused New Century to increase the repurchase reserve

The calculation of the New Century repurchase reserve was further flawed because New Century in the third quarter of 2006 continued to fail to take into account the growing Backlog Claims.

New Century experienced an increase in repurchase claims beginning in the fourth quarter of 2004 and continuing at a much greater rate in 2006. As such claims continued to grow, the Accounting Department continued to compute the quantity of loans that might need to be repurchased as of the close of a reporting period based on the assumption that only the loans that were sold in the prior 90 days before the financial statement reporting date would be susceptible to repurchase. This was a significant error, resulting in a material underestimate of the required repurchase reserve.

New Century failed to keep careful records of its unresolved repurchase claims. Had it kept careful records, it would have learned at an early date of the growing amount of Backlog Claims relating to loans sold before the 90-day look-back period. This is an internal controls deficiency, which is discussed in Section VIII. of this Final Report.

Even though New Century did not maintain accurate data regarding the growing Backlog Claims, their existence was no secret. For example, New Century's Treasurer, Jeffrey Goldberg, performed a liquidity analysis in June 2006. In doing so, he became worried about the level of repurchases, which had reached $200 million in the second quarter of 2006. This was the largest volume of repurchases in at least three years. In a June 13, 2006 e-mail transmitting his liquidity analysis to Dodge and Kenneally of the Accounting Department, Goldberg predicted that liquidity would drop to $310 million by the end of the year, which he characterized as being "at the low end of the range." He explained that the pressure on liquidity was coming from, among other sources, "a whole bunch of outstanding repurchase requests." According to Goldberg, the problem of the growing backlog of repurchase claims was a matter of "general knowledge" within the Accounting, Finance and Secondary Marketing groups. At a minimum, Goldberg's June 13, 2006 e-mail to the two senior members in the Accounting Department put them on notice that Backlog Claims existed and that someone needed to investigate to determine if they should be taken into account in the calculation of the repurchase reserve. The Examiner found no evidence that anyone in the Accounting Department undertook such an effort.

Other data also put the Accounting Department on notice that Backlog Claims were significant. For example, in September 2006, a Repurchase Activity document was created and was presented at the September 2006 Business Unit Review meeting, which was attended by many members of the Accounting Department. Indeed, the Examiner determined that Cloyd e-mailed the document to Dodge on September 6, 2006. The document noted that the author had estimated that $52.9 million of the $153.9 million in then-pending repurchase claims were from 2005 and that another $19 million in claims were more than three months old.

Similarly, between August and October 2006, New Century was seeking to better organize its tracking of repurchase claims. As part of that effort, Secondary Marketing concluded that, as of October 31, 2006, there were $421 million in outstanding repurchase claims. The data that were widely distributed within New Century in Key Indicator Reports and other documents, including to Dodge and Kenneally, showed the following:

Date	Pending Claims
December 31, 2005	$143,008,639
March 31, 2006	$281,625,528
June 30, 2006	$199,120,740
September 30, 2006	$399,757,399

The foregoing analysis, whether precisely accurate or not,[351] demonstrated that New Century had a large and growing amount of repurchase claims, a substantial portion of which likely were Backlog Claims, and that senior members of New Century's Accounting Department were aware of these data. However, they took no action to analyze whether such data required reexamination of the method of calculating the quantity of loans that were estimated to be subject to repurchase claims as of September 30, 2006. The Examiner discovered no satisfactory explanation for this failure.

The Examiner dismisses as not credible one such explanation. Certain Accounting Department personnel suggested that it was not until approximately January 2007 that they understood the magnitude of the potential backlog and its likely significance, blaming Secondary Marketing for failing to make the Accounting Department aware of Backlog Claims. Indeed, Kenneally told the Examiner that on January 10 or 11, 2007, while he and Sanchez were meeting with Weiss and Licata to discuss repurchase data, a "light went on" when Kenneally realized that there was a backlog. He told the Examiner that he had always believed that claims in the "pipeline" (*i.e.*, being evaluated and processed) were not material to the reserve calculation as long as the number of such claims remained stable over time. Sanchez similarly told the Examiner that he learned in January or February 2007 about the significant backlog of repurchase requests. He recalled learning this from Walker while she was working with Kim to correct the repurchase reserve. This explanation does not fit the facts.

As noted above, Kenneally and others in the Accounting Department were provided documents in at least June, September and October 2006 indicating that Backlog Claims existed. Despite this information, the Accounting Department failed to investigate. While the Secondary

[351] The Examiner sought to determine whether the data in the foregoing table were accurate. The Examiner could make no precise determination, especially with regard to the older data, given New Century's poor recordkeeping with regard to repurchase data. Nonetheless, the Examiner believes that this chart presents reasonable estimates of the repurchase claims pending at the indicated times.

Marketing Department could have done a much better job of regularly informing the Accounting Department of the quantity and vintage of repurchase claims, Accounting Department personnel were certainly on sufficient notice that their professional obligation was to conduct a careful analysis.

e. Fourth Quarter 2006: Questions About New Century's Repurchase Reserve

In November 2006, Bindra became New Century's CFO. Within two months, events unfolded that demonstrated that New Century's repurchase reserve calculation methodology was in error. The main milestones in this sequence of events may be summarized briefly.

On November 27, 2006, Bindra received an e-mail from Morrice, suggesting that it might be advisable to review the repurchase reserve, including its calculation, with a view toward increasing the reserve amount. Morrice's e-mail, which was copied to Dodge, Kenneally and Cloyd, stated:

> I saw in the most recent 4Q forecast a reference to increasing the repurchase reserve. Probably a good idea, but I would still like to review how we calculate the reserve. I am especially curious about this given that, as far as I know, we still do not have a good methodology for forecasting repurchases. Please advise on current approach.

Dodge responded to Morrice's e-mail in a way which gave no indication of the recent changes to the repurchase reserve calculation methodology:

> Actually we have always looked at a combination of historical experience and recent trends, the question is how much weight to put in the recent trends. In the third quarter we recognized the upward trend and increased the frequency factor to 1.75%. You can make an argument that we didn't go high enough, given the October requests, but November requests have been pretty light. To be safe, Dave and I felt that an additional reserve was warranted, at least for the forecast.

Bindra was confused by Dodge's e-mail. He asked:

> I am confused by patti response did we change from looking at historical information to trying to estimate the upcoming quarters repurchase level to estimate the level of reserve or not in 3q?

Kenneally responded to Bindra in an e-mail message that appears inconsistent with the changes to the method of calculating the repurchase reserve that Kenneally had implemented in the second and third quarters of 2006:

> *We really haven't changed the process or methodology.* We have always considered both the historical mathematical answer and then existing conditions

> and market trends, i.e., judgment. What ended up happening is that the market was fairly stable until we got into 2006, so history served as a good indicator/predictor until then, and was weighted fairly heavily as the primary driver.
>
> In 2006, particularly at the end of Q3, we acknowledged that history wasn't the best predictor/indicator of activity and weighted the trends and market conditions more heavily, and thus came up with an expected percentage that had more judgment involved that relying on the historical math as the primary driver. (Emphasis supplied.)

The highly selective description of the repurchase reserve calculation in Kenneally's e-mail suggests a lack of candor, particularly given that he began the e-mail by stating that New Century had not changed "the process or methodology" for the repurchase reserve calculation. That assertion is not accurate given that Inventory Severity and Future Loss Severity had been eliminated from the computation and Interest Recapture had been added to the computation. The Examiner acknowledges that Kenneally's e-mail focused on the use by New Century of historic versus current repurchase data as the best means for estimating the likely repurchase rate, which was the focus of Bindra's e-mail. However, Kenneally knew that a series of changes had been made to the repurchase reserve calculation methodology over the previous two quarters but did not mention them.

Shortly after this e-mail exchange, Kenneally prepared a draft memorandum on November 27, 2006 addressing the methodology for calculating the repurchase reserve. Kenneally's memorandum acknowledged that FAS 5, *Accounting for Contingencies*, applied to the recognition of loan losses, and that one of these contingencies was the allowance for loan repurchase losses - expenses and losses incurred due to the potential repurchase of loans. The memorandum identified the "return of premiums received from the investor, as well as a make whole of interest due to the investor," as the primary elements of expenses and losses related to loan repurchases.

Kenneally's memo did not mention that, prior to the third quarter of 2006, New Century excluded Interest Recapture from the reserve calculation. The memorandum also did not mention that New Century's calculation methodology included Inventory Severity through the first quarter of 2006 and Future Loss Severity through the second quarter of 2006.

Bindra remained unsatisfied with New Century's repurchase reserve after receipt of Kenneally's November 27 memorandum. He told the Examiner that his concern was prompted,

in large measure, by what he perceived as an apparent discrepancy between New Century's extremely high loan origination volume and relatively low repurchase reserve, which was $10.3 million when he arrived at New Century in November 2006. Because he believed New Century's repurchase reserve was far less than the comparable reserve for other mortgage banking companies and that its potential exposure to repurchase obligations was greater given larger origination volumes, Bindra continued to question how the New Century repurchase reserve was calculated and whether it was consistent with New Century's exposure to repurchase claims. Indeed, Bindra remained concerned, especially when he learned that New Century did not include severity components in the reserve, while the other companies did, based on an informal survey he conducted through personal and professional contacts in the mortgage banking industry.[352]

At or around this time, outside sources were noting the apparent differences between New Century's reserves and those of others in the industry. For example, in December 2006, the Center for Financial Research and Analysis ("CFRA") published a study comparing a number of mortgage companies, including New Century, across several important common measures. The study stated that New Century's loss rate on repurchases exceeded 26%, and that other lenders had a higher repurchase reserve than New Century to recognize these potential losses.

Kenneally wrote on January 15, 2007 what amounted to a rebuttal of the report's criticisms of New Century, disputing the conclusions of the report. Addressing the issue of the repurchase reserve, Kenneally stated that the Company's repurchase reserve made provision for the return of premium and interest, and that this was a concept "we have vetted in detail with KPMG." This rebuttal was circulated on January 15, 2007 to Morrice, Bindra, Cloyd and Dodge.

f. Discovery of the Repurchase Reserve Accounting Errors

In January 2007, New Century finally determined that it had materially and in multiple respects failed to calculate its repurchase reserve correctly for the first three quarters of 2006. A brief chronology of the discovery of those errors follows.

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[352] Bindra told the Examiner that in December 2006, after seeing Kenneally's November memo on the repurchase reserve, he inquired as to why the reserve did not contain a "severity" factor. Kenneally told Bindra that severity was already included in the company's LOCOM analysis and was thus unnecessary. In January 2007, Bindra continued to ask questions and was informed by Kenneally that severity had in fact been removed from the calculation during 2006. At this point, Bindra reviewed peer disclosures and discovered that the lack of severity was out of step with the methodology employed by comparable companies to estimate the appropriate reserve.

On January 18, 2007, only three days after his rebuttal to the CFRA report, Kenneally and Sanchez met with Kim, Donovan and KPMG's SOX manager for an initial meeting to "kick-off" the 2006 audit process. Kenneally led a discussion of the repurchase reserve. He reviewed the methodology changes that had been implemented in the second and third quarters, and distributed copies of FAS 65, 114 and 5. Kenneally told the Examiner that everyone at the meeting agreed they were comfortable with the methodology, including Donovan and Kim.

The next day, January 19, 2007, Kenneally recalled that he received an e-mail from Donovan in which Donovan advised Kenneally that he had done more research on the reserve calculation, which suggested that New Century's calculation of the reserve was wrong. Kenneally recalled that Donovan identified paragraph 55 of FAS 140 as the basis for his belief that the New Century calculation methodology was wrong. Donovan told the Examiner that he first learned of the changes to the reserve methodology around the time of the January 18, 2007 meeting. He maintained this position despite being shown documentary evidence that he had initialed and commented on the balance sheet analytic workpapers in the second and third quarters and year-end 2006, which identified these changes.

After he got Donovan's e-mail, Kenneally asked Sanchez to look at paragraph 55 of FAS 140 and Donovan's e-mail, which had been based on input from Macaulay, the KPMG concurring partner. Sanchez told Kenneally that he thought KPMG was right. Kenneally acknowledged to the Examiner that he was shocked. Kenneally then reviewed the accounting literature over the weekend and decided that Donovan was correct. On Sunday, January 21, 2007, Kenneally called Bindra to notify him of the issues. He told Bindra he would work with Secondary Marketing to quantify the impact of the accounting errors.

Kenneally told the Examiner that both Kim and Donovan separately acknowledged to him prior to the restatement announcement that the changes to the repurchase reserve methodology were Kim's idea.

Donovan told the Examiner that he initially regarded the error as limited to the misinterpretation of FAS 140 with respect to the second and third quarter of 2006 changes, but that Kenneally came to him and said the numbers were a lot bigger because of the Backlog Claims. Kenneally told the Examiner that he knew the impact of the accounting errors would be material.

On January 31, 2007, the Audit Committee met. At the meeting, Kenneally reported that the Company had used an inappropriate methodology for calculating the repurchase reserve starting in the second quarter of 2006. Zona asked if KPMG knew about the changes, and Kim acknowledged that the changes had been the subject of discussions between KPMG and New Century. Kenneally also reported on the backlog issue and Morrice advised the Audit Committee that the Company's controls with respect to the backlog issue had been inadequate. Donovan also took the position that these matters signified a deficiency in internal controls over financial reporting. Bindra advised the Audit Committee that KPMG and New Century would need to review the Company's financial statements to determine the effect that these accounting errors would have on prior period financial results.

On February 6, 2007, Kenneally prepared a memorandum for Terry Theologides, New Century's General Counsel, on the accounting issues related to the repurchase reserves, which estimated that the incorrect accounting resulted in an overstatement by $21.69 million, or 16.1%, of second quarter 2006 pre-tax earnings, and $13.01 million, or 12.3% of second quarter 2006 net earnings. This memorandum concluded that the accounting issue had no material impact on the second quarter of 2006, and that the Company could correct the errors by restating the third quarter financial statements and by changing its estimates reported in the year-end financial statements. These events led to the February 7, 2007 announcement by New Century that its financial statements for the first three quarters of 2006 needed to be restated.

4. Measuring the Amount of Understatement of the Repurchase Reserve

The chart below summarizes the various components of the repurchase reserve calculation for the first quarter of 2005 through the third quarter of 2006 and displays the changes made to the reserve methodology in the second and third quarters of 2006.[353] As the chart shows, the modifications and exclusions are directly related to the erroneous accounting which led to the February 2007 restatement announcement.

[353] Since the calculations of the repurchase reserve were consistent for each quarter of 2004 and 2005, analysis of data was only performed for 2005 and 2006.

Description	Q1 – 2006 & prior	Q2 – 2006	Q3 – 2006
Interest Recapture	Excluded	Excluded	Included
Premium Recapture	Included	Included	Included
Future Loss Severity	Included	Included	Excluded
Inventory Severity (LOCOM)	Included	Excluded	Excluded
Backlog Claims	Excluded	Excluded	Excluded

The Examiner sets forth below a summary of each of the material errors that contributed to the material miscalculation of the repurchase reserve.

a. New Century's Failure to Account for the Backlog

New Century's repurchase reserve calculation failed to include potential losses associated with the Backlog Claims. During 2005 and through September 30, 2006, Backlog Claims never were considered in New Century's calculation of its repurchase reserve. Estimated expenses and losses on an assumed percentage of Backlog Claims expected to be valid should have been taken into account along with estimated expenses and losses on projected future repurchase claims. The failure to consider Backlog Claims is particularly troubling because of the explosive growth of Backlog Claims between year-end 2005 and September 30, 2006.

The Examiner concludes that both New Century and KPMG bear responsibility for ignoring the Backlog Claims. New Century knew of a large number of reported but unresolved claims at year-end 2005 ($188 million) and a further mounting volume of repurchase claims by no later than June 2006. Similarly, KPMG's workpapers for the 2005 audit reflect knowledge of the $188 million in outstanding repurchase claims, but KPMG took no steps to test whether the New Century repurchase reserve calculation took any or all of these claims into account.

The Company and KPMG assumed that only loans that it had sold during the 90 days prior to the reporting date were at risk of repurchase and that it would not repurchase any loans from any prior period. In reality, beginning no later than 2004, New Century was receiving repurchase requests related to loans sold outside of the previous 90-day period and it was taking much longer than 90 days to evaluate and process repurchase requests and repurchase loans. New Century was not reserving, however, for these loans that it might be required to repurchase, and on which it might incur losses and expenses, but for which no reserve was provided. An example will put this error in perspective.

If New Century sold $10 billion in loans in one quarter (the fourth quarter of 2005) and assumed that the repurchase rate was 1%, then New Century would assume for its December 31,

2005 financial statement that 1% of the loans sold in the fourth quarter of 2005 would be repurchased. The loans assumed to be repurchased would be calculated as being $100 million and the various reserve components, *i.e.*, Premium Recapture, etc., would be computed upon the $100 million in loans. This methodology, however, left out the growing backlog of loans sold prior to the fourth quarter of 2005 as to which repurchase claims were pending as of December 31, 2005.

In connection with both its annual audits and quarterly reviews, KPMG examined the 90-day look-back assumption and concluded that it was reasonable. Several KPMG witnesses told the Examiner that New Century Management represented to KPMG that repurchase requests were usually received and processed within 90 days of the date the loans were sold. The witnesses told the Examiner that KPMG's engagement team tested this representation by Management in two ways: (1) it reviewed the loan sales agreements to confirm that they contained provisions requiring New Century to repurchase loans under certain conditions only within 90 days of sale; and (2) it reviewed New Century's repurchase log to confirm that repurchases were actually being processed within 90 days of the sale.

The Examiner does not accept KPMG's position. First, at year-end 2005, KPMG, as shown in its workpapers, was told that New Century had a $188 million backlog of repurchase claims. The Examiner determined that KPMG did not test whether any of these $188 million in claims related to loans sold before September 30, 2005. If KPMG had investigated, it would have concluded either that the $188 million in pending repurchases identified must have included claims relating to sales outside the most recent 90-day period or else the repurchase rate, assumed to be 0.659% based on historic averages, would be far too low. Either way, the significant reported number of Backlog Claims at the end of 2005 should have alerted KPMG to assess carefully whether the Company's approach to quantifying its true repurchase liability was appropriate. Instead, KPMG ignored the issue.

Second, the Examiner's review of the whole loan sales agreements revealed varying and inconsistent repurchase provisions among agreements. Similarly, an internal review conducted by New Century in the summer of 2006 revealed the same thing. A Repurchase Research presentation from August 2006 specifically noted as a factor contributing to the backlog, "high variability in sale terms deal to deal, with some creating greater exposure for NC." The presentation explained further, "no time limit on investor to request repurchase" and "greater

variability leads to longer validation time." The presentation recommended that loan sale agreements contain a "fixed time for notification of payment default" and a "standardized definition of payment default."

Third, if a repurchase request was based on a breach of representations or warranties contained in the loan documents, there was no time limit within which an investor was required to request that New Century repurchase the loan. It could request repurchase at any time during the life of the loan. Given the 90-day look-back assumption, losses incurred on the repurchase of loans based on breaches of representations and warranties that occurred after 90 days from the date of the loan sale were not accounted for in New Century's repurchase reserve. According to Lent, repurchase requests relating to breaches of representations and warranties increased significantly in mid-to-late 2006. Indeed, one Investor informed Lent that it had retained an outside firm to review the Investor's losses and that this might result in an increase of the number of repurchase requests based on breaches of representations and warranties.

Fourth, the loan sale agreement repurchase provisions relate only to the time within which an investor must "request" that New Century repurchase a loan and not the time within which New Century must actually "repurchase" the loan. Because New Century's repurchase reserve only took into consideration actual repurchases and did not account for repurchase requests received but not acted upon by the Company, the loan sale agreements could not have provided support for the 90-day look-back assumption in any event.

The Examiner also reviewed the repurchase log. The repurchase log identified loans New Century repurchased from 2001 forward.[354] The log identified the date New Century originally sold the loan and the date New Century repurchased the loan. It did not identify the date New Century received an investor's repurchase request. Accordingly, while the repurchase log contained sufficient information to confirm whether loans were actually repurchased within 90 days of sale, it could not confirm whether repurchase requests were received by New Century within 90 days of sale. Based on the Examiner's review of the repurchase log, New Century rarely repurchased loans within 90 days of the date the loans were sold. In most cases, the log reflected more than 90 days between the date the loans were sold and the date the loans were

[354] Given the lack of centralization of the repurchase process, it is not clear that the repurchase log was entirely accurate.

repurchased. The repurchase log, therefore, also does not provide support for the 90-day look-back assumption.

b. New Century's Failure to Account for Future Loss Severity

The Future Loss Severity component was included in the calculation of the repurchase reserve through the quarter ended June 30, 2006 but was eliminated for the quarter ended September 30, 2006. There is no justification for eliminating Future Loss Severity from the calculation, particularly in light of the significant increase in repurchase claims New Century was experiencing in 2006.

Kenneally said the removal of Future Loss Severity from the repurchase reserve calculation was based on discussions with KPMG and the belief that this severity component was already included in the Company's overall LOCOM analysis of repurchased loans in inventory. Kim maintained that although there were discussions about changes to the repurchase reserve calculation between KPMG and the Company, he did not advise New Century to make the changes. Indeed, he took the position that he was not informed of the changes when they were made.

The LOCOM rationale offered to support the elimination of Future Loss Severity from the calculation of the repurchase reserve for the quarter ended September 30, 2006 has since been abandoned. Kim told the Examiner that he informed Sanchez that New Century should only reserve for Premium and Interest Recapture, but that he no longer believed that was correct as a matter of accounting under FAS 140. In his February 2007 memorandum to Theologides, Kenneally acknowledged that LOCOM valuations of repurchased loans held for sale cannot substitute for Future Loss and Inventory Severity.

c. New Century's Exclusion of Inventory Severity

In the second quarter of 2006, New Century removed Inventory Severity from the repurchase reserve calculation because it was believed that this severity component was also already included in the overall LOCOM valuation adjustment. For the same reasons discussed above pertaining to Future Loss Severity, this accounting position is untenable and has been abandoned by New Century and KPMG. Kenneally stated in his February 6, 2007 memorandum evaluating the accounting issues related to repurchases that using the LOCOM analysis as a substitute for Inventory Severity "was not appropriate." Kim told the Examiner that even though

he once believed that there could be potential double-counting of the repurchase reserve if LOCOM adjustments were made on an aggregate basis, he no longer holds that view.

d. New Century's Failure to Account for Interest Recapture

Until the third quarter of 2006, New Century also failed to account for Interest Recapture in its repurchase reserve calculation. Chinn recalled to the Examiner that Kenneally believed as of the third or fourth quarter of 2005 that interest should be and was included in New Century's repurchase reserve calculation in the component known as estimated losses on future repurchases. However, an examination of the estimated losses on future repurchases used by New Century demonstrated that Interest Recapture was not included in its calculation until the third quarter of 2006. While the inclusion of Interest Recapture in the third quarter of 2006 was a correction which had the effect of making the reserve more appropriate, Interest Recapture should have been included in all calculations of the repurchase reserve in all periods.

e. Recalculation of New Century's Repurchase Reserve

The Examiner has sought to recalculate New Century's repurchase reserve, as well as its LOCOM adjustment. In undertaking this effort, the Examiner investigated not only the accounting errors already discussed but whether New Century used appropriate assumptions that were representative of then-current market conditions in 2005 and 2006. The Examiner determined that the historical data used by New Century to estimate its repurchase reserve spanned a number of years, with the number varying depending on whether New Century was estimating the repurchase percentage, the loss rate on sales of repurchased loans or some other number. During the bulk of this time period, the mortgage industry was experiencing low repurchase claims and low subsequent losses on loans repurchased. As described below, the Examiner recalculated various elements of the repurchase reserve using data that were more representative of market conditions existing at the time the reserve was estimated in 2005 and 2006.

The repurchase reserve is an estimate of the future expenses and losses to be incurred on loans to be repurchased and therefore should consider current trends. The Examiner believes that a 12-month look-back period, *i.e.*, data from the most recent 12 months, is appropriate for determining certain inputs used to estimate the repurchase reserve since this period more accurately depicts the market conditions facing the Company during 2005 and 2006. In his analysis, the Examiner also recalculated the Percentage of Repurchased Loans Sold at a Loss and

the Loss Severity Percentage using six-month and 18-month look–back periods, which did not result in materially different percentages than those determined using a 12-month look-back period. The Examiner believes that a 12-month look-back period does not give too much weight to short-term volatility and takes into account then-existing market conditions and trends.

While the concept of accounting estimates is fairly straightforward, judgment is required in developing estimates because estimates are based on subjective as well as objective factors. The Examiner recalculated revised approximations of the repurchase percentage, the repurchases sold at a loss, and Future Loss Severity using the most recent 12 months of history to better approximate the market conditions to which New Century was subject at the time. Because developing estimates requires the application of judgment based on information available at the time, other parties may arrive at somewhat different assumptions using the same information. However, the Examiner believes that the estimates used to recalculate the repurchase reserve are appropriate and reasonable in that they represent information that was available to New Century Management contemporaneous to estimating the reserve.

The Examiner summarizes below the assumptions used in the recalculation and then presents the recalculated numbers.

i. Examiner's assumptions used for recalculation of the repurchase reserves

(a) Repurchase Percentage

New Century estimated the volume of loans to be repurchased ("Repurchase Percentage") based on the percentage of loans repurchased in prior periods. The Repurchase Percentage was applied to whole loan sales that the Company assumed were still at risk, namely the whole loans sold in the most recent three months. The table below shows the Repurchase Percentage used by New Century for the periods reviewed by the Examiner and the percentages recalculated by the Examiner.

Repurchase Percentage

Period	NC %	Examiner
YE 2005	0.659%	1.000%
Q1-2006	0.689%	1.000%
Q2-2006	1.000%	1.000%
Q3-2006	1.750%	1.750%

In the fourth quarter of 2005 and the first quarter of 2006, New Century calculated the Repurchase Percentage by dividing all repurchased loans since January 2001 by the total whole loan sales for the same period, effectively creating a five-year historic average look-back period. The Examiner concluded that use of a long look-back period was inappropriate for the reasons cited above. Therefore, the Examiner recalculated the Company's Repurchase Percentage for the fourth quarter of 2005 and first quarter of 2006 using a one-year look-back period, arriving at a Repurchase Percentage for both periods of one percent.

For the second quarter of 2006, New Century reduced the look-back period because it wanted to weigh recent years more heavily to take account of a trend toward higher repurchase claims. Accordingly, New Century used a weighted average Repurchase Percentage for repurchases and whole loan sales since 2004, which resulted in a shorter look-back period.[355] In the third quarter of 2006, New Century determined that a forward looking Repurchase Percentage expectation of 1.75%[356] was appropriate to arrive at a more detailed and accurate analysis of the potential repurchase activity. The Repurchase Percentage for the third quarter of 2006 would have been 0.89% if New Century had applied the same methodology as the second quarter of 2006. The Examiner concludes that the Repurchase Percentages New Century used for the second quarter of 2006 and third quarter of 2006 were reasonable, since New Century updated the percentage in the second and third quarters of 2006 contemporaneously to account for changing market conditions.

(b) Percentage of repurchased loans sold at a loss

New Century developed the percentage of repurchased loans that would be sold at a loss by dividing the cumulative repurchases sold at loss by the cumulative repurchases per the repurchase log. The Examiner believes that a more current time frame should again have been used to reflect better changes in market conditions. Because the repurchase reserve represents a reserve for estimated losses to be incurred on loans to be repurchased in the future, the inputs used to estimate the repurchase reserve should take into consideration current market trends and assumptions about conditions expected to exist. Utilizing information obtained from New Century, the Examiner calculated the percentage of repurchased loans sold at a loss based on a

[355] If New Century had used the same methodology in the second quarter of 2006 as previous quarters, the Repurchase Percentage would have been 0.841%.

[356] Kenneally and Secondary Marketing determined that the repurchase requests would be between 2 - 2.25% but that 20 – 25% of these claims would be refuted.

12-month historic look–back period. The following table shows the percentage of repurchased loans sold at a loss as estimated by New Century and the Examiner for the periods reviewed.

Percentage of Repurchases Sold at a Loss

Period	NC	Examiner
YE 2005	52.84%	39.66%
Q1-2006	55.16%	48.11%
Q2-2006	53.89%	50.21%
Q3-2006	N/A[357]	68.57%

The Examiner's calculation resulted in a percentage that is more consistent with then-recent market conditions and is not impacted by the inclusion of sales from older periods, such as in 2002, 2003 and 2004.

(c) Future loss severity

Starting in the fourth quarter of 2005, New Century calculated Future Loss Severity for future loan repurchases as the actual losses incurred on discounted sales of repurchased loans between January 2003 and the current quarter. New Century determined the Future Loss Severity percentage by dividing the actual losses incurred on repurchased loans that were sold at a loss by the total face value (or principal) of repurchased loans sold at a loss. The Examiner believes that a more current time frame should have been used to better reflect changes in the market. The repurchase reserve represents a reserve for estimated losses to be incurred on loans to be repurchased in the future. Therefore, the information used to estimate the repurchase reserve should take into consideration current market trends and assumptions about conditions expected to exist, Utilizing information obtained from New Century, the Examiner calculated the Future Loss Severity percentage using a 12-month historic look-back period as compared to the longer timeframe used by New Century. The following table shows the Future Loss Severity percentage as estimated by New Century and the Examiner for the periods reviewed.

[357] New Century did not use a percentage in the third quarter of 2006 because it eliminated severity from its repurchase reserve calculation.

Future Loss Severity Percentages

Period	NC	Examiner
YE 2005	13.38%	11.79%
Q1-2006	13.78%	12.43%
Q2-2006	15.68	18.45%
Q3-2006	N/A[358]	25.28%

(d) Backlog claims

As stated previously, the best estimate of Backlog Claims at various time periods were as follows.

Date	Backlog
December 31, 2005	$143,008,639
March 31, 2006	$281,625,528
June 30, 2006	$199,120,740
September 30, 2006	$399,757,399

The Examiner's calculation of the repurchase reserve amount attributable to the Backlog Claims applied the same interest rate, premium percentage and severity components that were used by the Examiner for future loan repurchases. The Examiner applied a refutation rate of 28% against the loan repurchase backlog amount based on various sources of data from New Century. Kenneally stated in documents and at his interview that a 20-25% refutation rate was appropriate. The Examiner also discovered in KPMG's workpapers for the fourth quarter of 2006 a refutation rate against the backlog at that time of 28%. This was a weighted average calculation based on which time period the repurchase claims were originally sold. The Examiner elected to use the 28% identified in the KPMG workpapers rather than the range cited by Kenneally because the KPMG percentage was based on actual analysis of repurchase claims.

ii. Total repurchase reserve amount

The Examiner recalculated the repurchase reserve based on the changes in assumptions discussed above and the addition of the Backlog Claims. The following table breaks down the Examiner's estimates of an appropriate repurchase reserve by future sales and backlog:

[358] New Century did not use a percentage in the third quarter of 2006 because it eliminated severity from its repurchase reserve calculation.

Repurchase Reserve

($ in 000's)		YE 2005	Q1 2006	Q2 2006	Q3 2006
New Century's Repurchase Reserve & LOCOM					
New Century's Premium Recapture	a.	$ 1,137	$ 1,349 e.	$ 2,606 e.	$ 5,335 e.
New Century's Interest Recapture	a.	-	-	-	5,039 e.
New Century's Future Loss Severity	a.	4,392	5,566 e.	9,448 e.	-
New Century's Repurchase Reserve		5,529	6,915	12,054	10,373
New Century's Inventory Severity (LOCOM)	b.	8,272	8,394	-	-
New Century's Reserve and LOCOM		**$ 13,801**	**$ 15,309**	**$ 12,054**	**$ 10,373**
Examiner Recalculation of Repurchase Reserve and LOCOM					
Premium Recapture		$ 1,725	$ 1,964	$ 2,355	$ 5,464
Interest Recapture		1,956	2,484	2,122	5,161
Future Loss Severity		5,009	6,993	9,363	42,095
Backlog		8,351	19,846	19,633	62,481
Examiner's Repurchase Reserve		17,041	31,287	33,473	115,201
Inventory Severity (LOCOM)	c.	18,080	26,797	81,871	85,788
Total Examiner's Calculated Reserve and LOCOM		**$ 35,121**	**$ 58,084**	**$ 115,344**	**$ 200,989**
Difference between New Century's and the Examiners total reserve		**21,320**	**42,775**	**103,290**	**190,615**
Quarterly Income Statement Impact	d.	**21,320**	**21,455**	**60,515**	**87,325**

Notes:

a. Excludes Home123 repurchase reserve amounts.

b. Relates to the MTM on repurchased loans booked by the Company.

c. Includes only the Inventory Severity (LOCOM) on Repurchased Loans due to mispricing of loans in Q4 2005 and Q1 2006 and the exclusion of Inventory Severity in Q2 and Q3 2006. Does not include Industry Practice LOCOM, discussed in E, *infra*.

d. Does not constitute the total financial statement impact of the Examiner, as this excludes Industry Practice LOCOM, discussed in E, *infra*.

e. Includes certain immaterial reconciling items to financial statements.

5. New Century Failed Properly to Apply LOCOM to Loans Held for Sale

New Century reported repurchased loans pending resale on its balance sheet as part of LHFS. In accordance with GAAP, New Century was required to report its LHFS at LOCOM. The Examiner has determined that New Century not only failed to apply LOCOM consistent with industry practice, but also failed to account for its repurchased loans consistent with its own LOCOM policy.

Under GAAP, LHFS are reported at LOCOM, *i.e.*, they are reported at the lower of cost or market value. FAS 65, *Accounting for Certain Mortgage Banking Activities*, provides, in pertinent part:

> Mortgage loans held for sale shall be reported at the lower of cost or market value ("LOCOM"), determined as of the balance sheet date....The amount by which cost exceeds market value shall be accounted for as a valuation allowance. Changes in the valuation allowances shall be included in the determination of net income of the period in which the change occurs... (FAS 65, paragraph 4)

> The market value of mortgage loans and mortgage-backed securities held for sale shall be determined by type of loan. At a minimum, separate determinations of market value for residential (one- to four-family dwellings) and commercial mortgage loans shall be made. Either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of loan... (FAS 65, paragraph 9)

Under FAS 65, the proper application of LOCOM requires that a company, such as New Century, determine if the market value of LHFS is lower than the carrying amount of those loans. If it is, then a valuation adjustment is required with an offsetting charge to current earnings, generally as a component of gain on sale on loans.

Industry practice for conducting a LOCOM analysis is to first group the loans into generally like-kind (by type) loan categories to facilitate their pricing. For example, it is customary for a mortgage banking company like New Century to categorize mortgage loans into performing and non-performing categories since the market prices of such loans are very different.[359] Pursuant to the broad guidance in FAS 65, mortgage banking companies also customarily aggregate loans by product type and further separate "scratch and dent"[360] and non-performing loans for LOCOM testing purposes.[361]

Once the pricing categories are established, a company should then determine the market value for each category of LHFS. This market value represents the average selling price for each category of loans at the reporting date and would generally be determined by a mortgage banking company's secondary marketing department because of their direct access to, and knowledge of, market conditions. Categories of loans for which the market value exceeds cost are carried at historical cost. Categories of loans for which the market value is below cost are written down to market value by way of a valuation allowance.

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[359] FAS 65 does not specify how a company's loan categories should be aggregated (other than requiring commercial and residential loans to be aggregated separately), nor does it specify the level of aggregation.

[360] "Scratch and dent" loans are loans that are impaired in some manner and would therefore trade in the secondary market at a price less than a similar, but unimpaired, loan. The impairment could be caused by a number of factors, such as early payment default, missing documentation, or underwriting errors.

[361] This practice is derived from federal regulations applicable to banks, thrifts, and credit unions, which require that "scratch and dent," non-performing, and repurchased loans be categorized separately for purposes of the LOCOM analysis. The Office of Thrift Supervision has provided guidance on the classification and segregation of repurchased loans in Section 573 of the Mortgage Banking Examiners Handbook. While New Century was not specifically subject to these regulations, it is customary for mortgage banking companies to follow these practices as they relate to LOCOM analysis.

a. Management's Failure to Apply LOCOM Properly

The Examiner identified two issues with respect to New Century's application of FAS 65. First, prior to the second quarter of 2006, New Century calculated a LOCOM adjustment for repurchased loans included in LHFS as part of the repurchase reserve calculation, but reported this amount on its balance sheet as part of LHFS in the LOCOM valuation account. New Century's reclassification of this amount from the repurchase reserve calculation to a LOCOM valuation account when viewed in isolation may be unobjectionable. However, the Examiner determined that this process enabled the Company to apply the provisions of paragraph 55 of FAS 140, in that repurchased loans were effectively recorded at their fair value.[362] The Examiner further determined that the prices (or marks) that New Century used to value repurchase loans in the fourth quarter of 2005 and first quarter of 2006 were not consistent with the marks used in its LOCOM analysis for its LHFS portfolio. In addition, starting in the second quarter of 2006, New Century eliminated entirely this LOCOM adjustment for repurchased loans.

Second, the Examiner found that New Century did not apply LOCOM in a manner consistent with industry practice, thereby enabling the Company effectively to hide losses in its LHFS portfolio by offsetting losses in certain loan categories with gains in other loan categories.

The Examiner determined that New Century's loan trial balance ("LTB") included the following categories of loans:

- Performing
- Current Month
- Commercial
- Woodland Hills
- Repurchase Performing
- Repurchase Not Yet Boarded – NP
- Non-Performing
- Repurchases Non-Performing

In its application of LOCOM, New Century first determined the market value of these repurchased loans by loan category at the reporting date. Secondary Marketing provided the loan pricing used by the Accounting Department for this purpose. However, once New Century priced the loans by category, it collapsed those individual categories and re-aggregated the entire

[362] Under paragraph 55 of FAS 140, loans that are repurchased should be measured at fair value on the date of repurchase as if the transferor purchased the loans on that date.

LHFS portfolio for LOCOM analysis purposes.[363] As a consequence, loan losses in some categories, such as non-performing loans, were offset by gains in other categories. By utilizing this practice, New Century consistently determined that a LOCOM adjustment was not required. The result was that New Century did not mark down the value of the "scratch and dent" and other non-performing loans.

The following illustrates the manner in which the Company offset gains and losses among its various loan categories, resulting in no overall LOCOM adjustment.

($000's)	Market Value	LTB (Cost)	Variance
Commercial Loans	$2,650	$2,790	$(140)
Woodland Hills Repurchase Loans	445	583	(137)
Non-Performing	211,823	298,743	(86,920)
Repurchases Performing	76,114	91,275	(15,161)
Performing	7,671,976	7,497,289	174,686
	$7,963,011	$7,890,681	$72,329

The LTB amount, in the aggregate, was then added to the net Premiums, FAS 91, *Adjustments and Discounts* ($29,497 at June 30, 2006), to arrive at total cost of $7,920,179. Because the total cost was lower than the market value ($7,963,011), no LOCOM adjustments were recorded.

This practice of re-aggregating loans into a single category after the loans were priced, and using gains to offset losses, is inconsistent with industry practice and the interpretation of FAS 65 as applied by financial institutions and various other mortgage banking companies. In practice, mortgage banking companies typically recognize a LOCOM valuation allowance for categories of loans where the market value is below cost, especially for non-performing loans and repurchased loans.

By virtue of this practice, the Examiner determined that New Century's LHFS portfolio was overstated for at least the year ended December 31, 2005 and for the first three quarters of 2006. In other words, if New Century had performed its LOCOM analysis consistent with industry practice, changes in the LOCOM valuation allowance would have been recorded against earnings. So, for example, by not applying LOCOM consistent with industry practice, New Century overvalued its LHFS portfolio at March 31, 2006 and June 30, 2006 by $22.3 million and $102.4 million, respectively, overstating pre-tax earnings by $80.1 million for the second quarter of 2006.

[363] New Century would value the loans based on different "buckets" and then "price out" each bucket to determine a blended price for all of the buckets together.

Further impacts of this practice are quantified below, which show that New Century would have incurred charges to pre-tax earnings had it properly accounted for its LOCOM adjustments consistent with industry practice. Instead, by off setting the LOCOM effects of lower value loans with the LOCOM effects of higher value loans, New Century was able to avoid adjusting the value of its "scratch and dent" and other impaired loans, thereby avoiding charges to pre-tax earnings.

In the CFRA study done in December 2006, New Century was criticized for recognizing the losses on repurchased loans only at the time of the resale of the loan, which not only affected the timing of the losses, "but likely signifies that material 'unrealized' losses remain embedded in New Century's loan portfolio. . . ."

Kenneally's "rebuttal" to this criticism consisted of resisting the terms used. He wrote, in a memorandum dated January 15, 2007, to Morrice, Bindra, Cloyd and Dodge that New Century is not recognizing "'repurchase' expense at the time of sale," referring to the terms used in the CFRA report. Instead, according to Kenneally, New Century was "disposing of inventory at a loss." He acknowledged that no LOCOM valuation was done, but justified this by asserting that KPMG approved the aggregation of loan categories, had told him this is what "most" people do, and that "the entire portfolio of loans held for sale is greater than its cost."

Carol Franchi, the person who performed the LOCOM analysis for Kenneally, described how in early 2007 she was asked by Kenneally, for the first time, to perform the LOCOM analysis on an individual loan basis. Kenneally also asked her to compare the actual marks, *i.e.*, what the repurchased loans actually sold for, for several prior quarters, and to compare them to the marks used for the LOCOM analysis of the same in those quarters. This analysis led her to conclude that the LOCOM calculation, at least for the second quarter of 2006, had been inaccurate.

To be fair, Kenneally's defense of the LOCOM process is more plausible once the specific accounting is considered. As described previously, prior to the second quarter of 2006, New Century effectively calculated a LOCOM adjustment, albeit using incorrect pricing, for repurchased loans that were included in LHFS as part of the repurchase reserve calculation. This LOCOM adjustment was designated on the relevant repurchase reserve worksheets as "***MTM on Repurchases not yet Sold.***" At the end of each reporting period, New Century reclassified the LOCOM adjustments related to repurchased loans (*i.e.*, the "***MTM on Repurchases not yet***

Sold") to the LOCOM valuation account for LHFS.[364] New Century's reclassification of the "***MTM on Repurchases not yet Sold***" to the LHFS valuation account had the effect of creating a LOCOM adjustment for repurchased loans not yet sold included in the Company's LHFS portfolio.

Consequently, until the second quarter of 2006, it was New Century's accounting policy to provide a LOCOM adjustment for repurchased loans. When the Company decided to remove the "***MTM on Repurchases not yet Sold***" component from its period end analysis of the repurchase reserve, it effectively eliminated the LOCOM valuation account for repurchased loans reported with LHFS, thereby recognizing amounts in the valuation account into income and no longer providing a LOCOM adjustment for repurchased loans.

The "***MTM on Repurchases not yet Sold***" reclassification at period-end essentially approximated the proper accounting for repurchased loans pursuant to paragraph 55 of FAS 140,[365] in that most of the amount reclassified to the LOCOM valuation account appears to represent the difference between the estimated fair value of the loans repurchased on the date of repurchase and their par value, although it is possible that some portion of this reclassified amount may have represented a further reduction in the fair value of the repurchased loans from the date of repurchase to the end of the reporting period.

Because repurchased loans were included in LHFS,[366] Kenneally and others in the Accounting Department, as well as Kim, incorrectly believed that a mark-to-market adjustment for the same loans was being performed -- the purported risk of double-counting. However, because New Century netted gains and losses among the various loan categories when performing its LOCOM analysis, *i.e.*, it used gains in certain loan categories to entirely offset losses in the other loan categories, it did not recognize a LOCOM adjustment or expense during any of the reporting periods for 2005 or 2006, except for repurchased loans that, prior to the

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[364] Account 1135-0000 "Loan Loss Reserve" is a contra-asset that offsets, or reduces, the LHFS.

[365] When the Company repurchased loans, they were added to the LHFS portfolio at par value and the excess of the repurchase price paid over the par value was charged to the gain on sale account (or in some instances to the repurchase reserve). Paragraph 55 of FAS 140 requires a Company to initially measure repurchased loans (assets) "at fair value on the date of [repurchase], as if the [Company] purchased the assets... on that date." Therefore, to the extent that the "***MTM on Repurchases not yet Sold***" was nearly equivalent to the difference between the repurchase price and the fair value of the loans on the date of repurchase, the Company appears, in this respect, to have complied with the requirements of FAS 140, but perhaps may have done so inadvertently.

[366] The LTB detailed loan by loan all the loans that comprised the LHFS on the Company's financial statements.

second quarter of 2006, were reflected in the Company's repurchase reserve worksheets as "***MTM on Repurchases not yet Sold.***"

b. Recalculation of New Century's LOCOM Adjustment

To better understand the impact of New Century's improper accounting related to LOCOM, the chart below compares New Century's actual LOCOM valuation with a recalculation of what the proper LOCOM valuation should have been, and the impact of the difference for year-end 2005 and the first three quarters of 2006.

($000s)	New Century's LOCOM	Examiner's LOCOM		Difference in LOCOM	Difference Related to Repurchased Loans[367]	Difference in LOCOM Amount[368]
YE 2005	8,272	21,170		12,898	9,808	**3,090**
Q1 – 2006	8,394	30,678		22,284	18,403	**3,881**
Q2 – 2006	0	102,358		102,358	81,871	**20,487**
Q3 – 2006	0	116,362		116,362	85,788	**30,574**

[367] These amounts relate to New Century's use of incorrect loan prices for the fourth quarter of 2005 and first quarter of 2006 and the elimination of a LOCOM adjustment for repurchased loans beginning in the second quarter of 2006.

[368] These amounts relate to New Century's application of LOCOM in a manner inconsistent with industry practice. The Examiner determined that these amounts cannot be considered misstatements because the application of the LOCOM requirements pursuant to FAS 65 is subject to varying interpretation.

B. Residual Interests

1. Executive Summary

The Examiner focused significant attention on the manner in which New Century valued the dozens of residual interests that New Century held in off-balance sheet securitizations. The Examiner did so because serious questions about those valuations had been raised by the Company itself, when it announced the likely need to restate its 2005 and 2006 financial statements, and by the Special Investigation Committee that reviewed New Century's accounting practices in the spring of 2007.

In general, the Examiner found that New Century relied for far too long on antiquated and flawed internally-developed Excel-based models to value residual interests that represented hundreds of millions of dollars of assets on New Century's books. As of December 31, 2005, residual interests in off-balance sheet securitizations were valued at $234.9 million on New Century's balance sheet. The Examiner found that the people at New Century most knowledgeable about these models were well aware of the models' flaws and had suggested that New Century use professionally developed third-party models instead. KPMG's engagement team also repeatedly found evidence of those flaws. Nevertheless, for cost reasons or because of institutional inertia, New Century continued to use models that, in at least one instance, produced a valuation error in 2005 of $9 million as to just one particular residual interest – an error that was not discovered until months after KPMG's audit of New Century's 2005 financial statements. The Examiner's review of New Century's residual interest models also revealed mathematical routines that were inconsistent, the "hard-coding" of certain data cells in order to override certain mathematical routines, and an inability of the models to process all of the data relevant to New Century's residual interest calculations.

Everyone at New Century who was familiar with the Company's models for valuing its residual interests – including members of the Board, the highest levels of New Century's Senior Management, the Company's chief financial and accounting officers, and the people within New Century's Secondary Marketing Department who built and operated the residual interest valuation models – understood that the accuracy of the results produced by those models depended heavily upon key assumptions. Yet many of those assumptions were flawed in ways that tended to result in inflated valuations of New Century's residual interests. New Century's own internal analyses in February 2007 concluded that, when proper assumptions were applied,

New Century's residual interests would need to be written down by approximately $90 million from the amounts at which they were valued as of September 30, 2006.

For instance, a critical assumption in each residual interest model was the discount rate that was used to compute the present value of the future cash flows to which New Century was entitled. The Examiner has determined that New Century insisted on using unduly low discount rates (of 12% for some residual interests and 14% for others) in both 2005 and 2006 that led to an overvaluation of New Century's residual interests of no less than $14.8 million (6.3%) as of December 31, 2005 and of comparable amounts in the quarters that followed. Not only New Century's Management, but ultimately its independent Directors as well, repeatedly resisted warnings from specialists at KPMG, who warned that the discount rates New Century was using were below those used by most of its peers. The Examiner's review has determined that during 2005 New Century's peer firms were using discount rates that ranged from 15% to 21%. The Examiner has concluded that the logic of New Century's own residual interest valuation analyses in late-2006 and early 2007 suggest that New Century should have been using discount rates that were at least 3 percentage points higher than those it did use during 2005 and 2006, *i.e.*, that it should have used discount rates of at least 15% and 17% during those accounting periods.

New Century's residual interest models also relied upon improper assumptions about the likely values of the remaining loans in the off-balance sheet securitization trusts at the times when those trusts were "cleaned up" or terminated because the unpaid principal balances of those trusts made them uneconomic to service. New Century uniformly – and without much thought or any reexamination – assumed that all of those loans could be sold at par, regardless of their delinquency status or market conditions. Only in early 2007, after serious doubts had arisen about the valuation of New Century's residual interests, did its Senior Management acknowledge that their unthinking reliance upon the "par value" assumption had been a mistake. The Examiner has determined that by improperly relying upon the par value assumption, New Century's residual interest valuations as of December 31, 2005 were overstated by no less than $27.5 million (11.7%). The valuations reported in subsequent quarters were similarly overstated.

The Examiner found that there were flaws in other key assumptions used in New Century's residual interest models, including the assumptions regarding how quickly loans in the off-balance sheet securitization trusts would be prepaid, the losses they would incur, and the dates upon which the trusts would be terminated. Although the Examiner has not tried to

quantify the specific financial statement impacts of these other flawed assumptions, the Examiner has observed that these flaws frequently resulted in inflated residual interest valuations and often persisted in the face of internal criticism and questions from New Century's independent auditors.

Finally, the Examiner has found that New Century's residual interest valuation process was infected by a dangerous lack of internal controls. The Examiner could not find any significant documentation that explained the operation of New Century's residual interest valuation models or the manner in which the assumptions used in those models were established, revised or approved by Senior Management. This lack of documentation not only interfered with the Examiner's investigation, but complicated previous efforts by auditors and others to understand and verify the accuracy of the models and their results. The lack of useful documentation about the models also created significant "key man" risks, because in many cases only one or a few people at New Century understood how the residual interest valuation models worked. In addition, it appears that the models themselves were not adequately safeguarded from access by people outside the Secondary Marketing Department who were responsible for operating the models and testing their results.

2. New Century's Residual Interests

a. Residual Interests – in General

New Century sold many of the mortgage loans it originated by packaging pools of such loans into trusts that issued securities for sale to investors. These investors received certificates representing senior interests in the cash flows generated by the loans in the trust. New Century, as the sponsor of the securitizations, was paid a cash price for the pool of mortgage loans it sold to the trust, and also retained a small ownership interest in each securitization trust known as a "residual interest."[369] In general, New Century's "residual interest" represented its right to cash flow or assets remaining in the trust after all investors in the securitization had been paid the principal and interest to which they were contractually due under the applicable trust documents and after the trust's expenses (including servicing fees, guarantor fees and other trust expenses)

[369] New Century's December 31, 2005 Form 10-K, pages F-14 and F-15.

had been paid.[370] New Century's residual interests were documented by certificates evidencing its residual interest ownership in the trusts.[371]

In general, New Century's residual interest in a securitization trust was related to the additional assets, above the aggregate principal value of the securitization, that New Century put into the trust's over-collateralization ("OC") account when the trust was created. The OC account represented a form of credit enhancement for investors in the trust, which gave them "a margin for error" in case the loans in the trust did not produce adequate cash flows to meet their expectations. As such, a trust's OC requirements could increase "investor confidence" in a securitization. Because of the "credit enhancement" features of these securitization trusts, they were often referred to as Credit Enhancement "CE" securities.

As New Century explained in its Form 10-K disclosures, each trust's "[o]ver-collateralization requirements [were] generally based on a percentage of the original or current unpaid principal balance of the loans [in the trust] and [could] be increased during the life of the transaction depending upon actual delinquency or loss experience." In general, New Century would not receive cash flow from its residual interest in a securitization trust unless the trust's over-collateralization requirements had been met. If investors received the payments they were expecting from the trust, New Century might not only receive cash flow associated with its residual interest in the trust, but might also be entitled to a return of the cash from that trust's OC account after the trust had been in existence for a certain time period.[372] On the other hand, if a trust drew down on its OC account to pay investors, New Century's residual interest in the cash flows generated by the loans in the trust would be reduced by a transfer of assets into the OC account, to restore it to agreed upon levels.

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[370] In general, the investors received the principal collected, including prepayments, from the cash flows generated by the loans in the trust. In addition, they received a portion of the interest on the loans in the trust equal to the specified "investor pass-through interest rate" on the principal balance of those loans.

[371] New Century's residual interests were subordinate to the interests of other holders of certificates in the securitization trusts until they were fully paid, but those certificate holders and the securitization trusts had no recourse against New Century in the event that the loans in the various trusts did not perform as expected.

[372] New Century, as the trust sponsor, typically would be entitled to a lump sum payment from the trust's OC account thirty-seven months after the trust was created. *See* Prospectus Supplement dated February 22, 2002 for Securitization 2002-1 ("On and after the Stepdown Date and provided that a Trigger Event is not in effect, the required Overcollateralized Amount may be permitted to decrease or step down . . ."). The Prospectus defined the "Stepdown Date" as March 2005, which was 37 months after the prospectus date of February 2002.

Thus, during the useful life of a securitization trust, New Century, as the holder of a residual interest in a CE securitization trust, would receive cash flows from its residual interest in the trust if the cash flows generated by the mortgage loans in the trust exceeded the trust's current obligations to pay bondholders and to pay expenses and if the trust's over-collateralization requirements had been met. In addition, New Century also would receive returns of amounts New Century had deposited in a trust's OC account when the trust met certain benchmarks.[373] This meant that the cash flow from a particular securitization trust could be substantial, but irregular and difficult to predict.

When a securitization trust moved toward the end of its useful life, New Century, as the sponsor of the securitization, generally had a contractual option to end or "collapse" the trust. When a trust was "collapsed," the trust's sponsor would pay off any remaining obligations to bondholders and, by exercising its option, take possession of any remaining assets in the trust. Most trust sponsors would collapse a trust when the balance of loans held in the trust fell below a certain level because the servicers of the loans in the trust – who typically receive fees of 2.5% to 5% of the value of the loans they are servicing – would experience diminishing returns on servicing loans as the trust's loan balance declined.

b. Net Interest Margin Securities ("NIMS")

Rather than receive cash flows from a residual interest in a CE securitization trust on a current basis over the life of the trust, the holder of a residual interest could securitize those expected cash flows as well by creating Net Interest Margin Securities ("NIMS"), which would be supported by most of the residual interest holder's right to receive, for a period of years, the trust's residual asset cash flow (the trust's current residual interest cash flows plus the right to the trust's over-collateralization balance and any penalties paid when loans in the trust were paid off prematurely minus any losses incurred on loans that defaulted or were delinquent). A NIMS transaction might occur concurrently with or shortly after a CE securitization.

For example, in 1999 New Century sponsored a NIMS securitization (NIMS 99-1) that securitized most of the residual asset cash flows that New Century held in CE securitizations New Century had sponsored in 1997 and 1998, respectively. As the sponsor of a NIMS, New Century received a portion of the discounted net present value of the residual interests' cash

[373] If certain requirements were met, New Century would also receive a portion (from 5-10%) of the principal balance of the trust if bondholders had received all scheduled payments as of a certain anniversary date.

flows in the form of an up-front payment at the closing of the NIMS transaction, rather than a receipt of cash flows over the life of the loan pool. In return, the investors in the NIMS received the right to receive, as a pass-through, a portion of the residual interests' cash flows collected by the NIMS trust with the sponsor of the NIMS entitled to receive any excess cash flows.

As the sponsor of a NIMS, New Century retained a residual interest in the NIMS trust as well, which would remain an asset on its balance sheet. A NIMS trust did not, however, offer the credit enhancement feature (in terms of over-collateralization) associated with other securitization trusts nor would New Century, as the sponsor of a NIMS, be obliged to pay the NIMS investors if the residual interest cash flows received by the NIMS trust from the underlying CE securitizations fell short of expectations. As a result, the interest rates paid to NIMS investors were higher than the interest rates on CE securitization trusts – to compensate those investors for their greater risk.

c. New Century's Off-Balance Sheet and On-Balance Sheet Securitizations

New Century's residual interests were large assets of the Company (worth hundreds of millions of dollars), but how they were valued and disclosed on New Century's financial statements depended on whether the securitizations associated with those residual interests were structured as "sales" or "financings" for accounting purposes.

If a securitization was structured as a "sale," New Century would record a gain on the sale of a portfolio of loans to the securitization trust, remove those loans as assets from its balance sheet, and, as required by applicable accounting rules, record and disclose its residual interest in the off-balance sheet securitization as a separate asset for accounting purposes. If a securitization was structured as a "financing," New Century would not record a gain on the transfer of its loan portfolio to the securitization trust because those loans would remain on New Century's balance sheet (referred to as on-balance sheet or "OBS" securitizations), and New Century's residual interest in that securitization would not be separately recognized.

New Century's first off-balance sheet securitization occurred in 1997. Between 1997 and 2002, the Company closed 30 off-balance sheet securitizations (referred to as the "pre-2003 securitization deals"), each of which resulted in the recognition of residual interests on New Century's balance sheet. As discussed previously, these off-balance sheet securitizations consisted of CE securitizations and NIMS securitizations. Prior to January 2003, New Century disposed of mortgage loans only through whole loan sales and off-balance sheet securitizations.

Off-balance sheet securitizations were less common after New Century became a REIT and decided to build up its OBS REIT portfolio.

Beginning in 2003, New Century began to do OBS securitizations. These OBS securitizations were done at the REIT (or "QRS") level or at the non-REIT (or "TRS") level. The decisions about whether to do securitizations as OBS or off-balance sheet securitizations, and whether to do OBS securitizations at the QRS or TRS levels were influenced by financial and economic considerations, and by REIT requirements, that are beyond the scope of this discussion of residual interest valuation.

New Century closed four OBS securitizations at the non-REIT level in 2003, because these deals were originated before New Century became a REIT in late-2004, and five OBS securitizations at the REIT level in 2004. New Century did not close any securitization transactions accounted for as sales in 2003 or 2004. In 2005, New Century closed eight securitizations, including four OBS securitizations at the REIT level and four off-balance sheet transactions treated as sales (the residual interests of which were all included in NIMS trusts). All four of New Century's securitizations in 2006 were OBS transactions at the REIT level.

The four securitizations structured as sales during 2005 totaled $6.4 billion in assets. The gain on sale that New Century recorded when these four securitizations closed was $141.5 million, and the value of the Company's residual interests in those securitizations was $97.5 million. As of December 31, 2005, the off-balance sheet trusts in which the Company held residual interests owned $6.9 billion in loans.

d. The Reported Values of New Century's Residual Interests in Off-Balance Sheet Securitizations

New Century's residual interests in off-balance sheet securitizations have always been a significant asset of the Company, because the Annual Percentage Rate, or APR, paid on the mortgage loans in each securitization trust was relatively high in comparison to the "pass-through" interest rate paid to investors who held senior certificates in the trusts. As indicated by the table below, New Century's residual interests in off-balance sheet securitizations represented a much larger percentage of the Company's total assets prior to 2003:

Period	Value of Residuals+	Total Assets+	Residual Interests as a % of Total Assets
Q4 2000*	$361,646	$837,161	43.20%

Period	Value of Residuals+	Total Assets+	Residual Interests as a % of Total Assets
Q4 2001*	$306,908	$1,451,318	21.15%
Q4 2002*	$246,964	$2,402,928	10.28%
Q4 2003*	$179,498	$8,943,938	2.01%
Q4 2004*	$148,021	$19,051,944	0.78%
Q1 2005	$143,928	$21,727,408	0.66%
Q2 2005	$145,563	$26,431,980	0.55%
Q3 2005	$172,111	$29,087,243	0.59%
Q4 2005	$234,930	$26,147,090	0.90%
Q1 2006	$208,791	$24,821,182	0.84%
Q2 2006	$209,335	$27,325,399	0.77%
Q3 2006	$223,680	$25,059,768	0.89%

+ Dollars in thousands.
* Data from New Century's 2004 Form 10-K. Remaining data from New Century's other Forms 10-K and 10-Q.

At some points between 1996 and 2000, the value of New Century's residual interests represented a major portion of the Company's total assets. In 2002 or 2003, New Century decided to reduce the size of its residual interests, in part because of the difficulty of valuing those assets.

New Century's residual interests in off-balance sheet securitizations were also a source of annual cash flow. During 2005, the Company's residual interests provided $17.5 million in cash flow to the Company.

e. Accounting Principles That Governed New Century's Valuation of Its Residual Interests in Off-Balance Sheet Securitizations

The remainder of this section of the Report will deal with the valuation of New Century's residual interests in off-balance sheet securitizations, because, for the reasons set forth above, these were the only residual interests that were reported as separate assets on New Century's financial statements.

The accounting standard that applied to the valuation of New Century's residual interests in securitizations structured as sales was Financial Accounting Standards Board ("FASB") Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and

Extinguishments of Liabilities – A Replacement of FASB Statement No. 125 ("FAS 140"). FAS 140 specifies that, upon completion of a transfer of financial assets (for example, the sale of mortgage loans to a securitization trust) that satisfies the conditions to be accounted for as a sale, the transferor (seller) should initially measure at "fair value," among other things, the residual interests obtained as a result of the transfer. Subsequent to the sale, FAS 140 requires that residual interests continue to be measured at "fair value."

Paragraphs 68–70 of FAS 140 provide some general guidelines for "fair value" measurements. FAS 140 defines the fair value of an asset as the amount at which that asset could be bought or sold in a current transaction between willing parties – that is, other than in a forced or liquidation sale. If quoted market prices are not available, the estimate of fair value is to be based on the best information available in the circumstances. Estimates of fair value should consider prices for similar assets and the results of valuation techniques to the extent they are available. One example of a valuation technique described in FAS 140 is computation of the present value of estimated future cash flows.

Because residual interests were not traded on an exchange during the relevant time period, many mortgage companies, including New Century, valued their residual interests in off-balance sheet securitizations based on the present value of the estimated future cash flows associated with those residual interests. FAS 140 recognized this valuation methodology and provided the following broad valuation guidelines for using it:

- Assumptions used for interest rates, default rates, prepayment rates, and volatility should incorporate what market participants would use in similar circumstances.
- Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections.
- All available evidence should be considered in determining the assumptions. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively.

If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes should be considered either directly, if applying an expected cash flow approach, or indirectly through a risk-adjusted discount rate, if determining the best estimate of future cash flows.

Another accounting standard that applied to New Century's valuation of residual interests in off-balance sheet securitizations was EITF Issue No. 99-20, Recognition of Interest Income

and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets ("EITF 99-20"). EITF 99-20 provides accounting guidance for how a transferor that continues to hold an interest (for example, a residual interest) in securitized financial assets should account for interest income from those assets and for any impairment in the value of those assets. Among other things, EITF 99-20 specifies that the holder of a residual interest should recognize the excess of all cash flows attributable to the interest estimated at the transaction date over the initial investment as interest income over the life of the interest using the effective yield method. EITF 99-20 also specifies that if the holder's best estimate of cash flows indicates there has been an adverse change in estimated cash flows, then: (1) an other-than-temporary impairment should be considered to have occurred; and (2) the beneficial interest should be written down to fair value with the resulting change being included in income.[374]

f. The Use of Models to Value New Century's Residual Interests

On the basis that residual interests in off-balance sheet securitizations were not bought and sold in well developed markets, New Century attempted, pursuant to FAS 140, to determine the "fair value" of its residual interests in CE securitizations and NIMS as balance sheet assets by using models to calculate the discounted net present value of the expected cash flows associated with those assets. New Century used these models to record the fair value of its residual interests when they first became assets and then to update and revise those values as New Century received new information and/or updated the assumptions the models relied upon.

In general, the residual interest valuations computed by these models depended on several key factors, including: (1) the nature of the residual interest held in each trust;[375] (2) the extent to which the trust was over-collateralized; (3) the prepayment fee income the trusts could expect to receive as certain loans in the trust were prepaid; and (4) losses the trust could be expected to suffer as borrowers defaulted or became delinquent in making their payments.

Each model would compute a net present value of the cash flow that New Century expected to receive over the life of the securitization from its residual interest in the mortgage loans held as collateral by each securitization trust, based on a combination of assumptions

[374] EITF 99-20, paragraphs 4, 11, and 12.

[375] The nature of New Century's residual interest would be defined by the securitization documents and would depend, in part, on the "pass-through" rates paid to the holders of senior certificates in the securitization trusts and the interest rates associated with the mortgage loans held as collateral in the securitization trust.

regarding that cash flow. As the trusts matured, some of the assumptions in those models would be replaced or updated by actual performance data. The assumptions in the models included expected prepayment speeds,[376] expected losses on the loans held in the securitization trust,[377] anticipated prepayment penalty income,[378] prevailing interest rate estimates,[379] whether the loans were expected to be held to maturity or sold when the trust was terminated pursuant to a clean-up call, the clean-up call percentage,[380] and the expected value of the loans remaining in the trust when it was terminated.[381] NIMS models essentially inherited the cash flows and related assumptions from the underlying CE securitization models. In addition, the models relied upon discount rates to convert the anticipated net cash flows from the residual interest in the trusts into net present values.

Because each securitization had its own unique set of loans with its own special deal terms, each securitization had its own valuation model, although most of the models shared the same mathematical functions and had similar types of assumptions. Although there were many different assumptions in the models, the conditional prepayment rate ("CPR") and loss assumptions may have had the greatest impacts on the cash flows estimated by the models. Discount rates, which were used to compute the present value of those cash flows, could also have a significant impact on a model's residual interest valuation.

As discussed below, New Century made various changes to the CPR and loss assumptions, as well as to other assumptions that were important to the models' operation. The

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[376] Prepayment speeds were expressed in a CPR, which was based on historical experience with regard to both voluntary prepayments of loans and loans removed from the trust's collateral pool as a result of foreclosure.

[377] Loan loss "severity," expressed as an annualized percentage of the outstanding loan balance, was based on historical losses for loans of the relevant type. As will be described below, actual loan losses were populated into the models each quarter.

[378] Prepayment penalties were calculated based on the ratio of loans in the collateral pool with prepayment penalties, and that ratio was applied against the original loan balance.

[379] Interest rates were based on a daily feed of projected LIBOR interest rates from Citigroup. These interest rates were used to forecast the rates for one-month, three-month, six-month and one-year LIBOR-based interest rates.

[380] The clean-up call percentage was the pre-determined percentage of the original loan balance at which New Century could exercise its clean-up call option and collapse the trust or securitization. The clean-up call percentage, which was set in the applicable securitization documentation, was usually no higher than 10% of the original loan balance.

[381] The terminal values of these loans were represented as the percentages of par value at which, according to the model, the underlying loan collateral could be sold upon collapsing the trust. As we will discuss below, until early 2007, New Century's residual interest models always assumed that this percentage was 100%, *i.e.*, that all remaining loans in the trust could be sold at par if and when the trust was terminated.

frequency of these assumption changes varied over time, and it is unclear who bore ultimate responsibility for making many of those changes. On the other hand, as also discussed below, New Century rarely changed the discount rates used in its residual interest valuation models. In 2005 and 2006, those discount rates were lower than market conditions justified.

In its 2005 Form 10-K, New Century described its methodology for valuing residual interests as follows:[382]

- First, New Century recognized that the performance of the mortgage loans in the securitization trusts would impact its ability to realize the current estimated fair value of these residual assets.
- As a result, New Century performed an evaluation of its residual interests quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors.
- In determining the value of its residual interests, New Century estimated the future rate of loan prepayments, prepayment penalties that would be received as loans were prepaid, loan delinquencies, loan defaults and default loss severity as they affected the amount and timing of the estimated cash flows from the off-balance sheet securitization trusts.
- New Century estimated prepayments by evaluating historic prepayment performance of its loans and the impact of current trends. New Century used a prepayment curve to estimate the prepayment characteristics of the mortgage loans in the securitization's portfolio. According to New Century's Form 10-K disclosures, the rate of increase, duration, severity, and decrease of the curve depended on the age and nature of the mortgage loans in the securitization trust, primarily whether the mortgage loans were fixed or adjustable and the interest rate adjustment characteristics of the mortgage loans (six-month, one-year, two-year, three-year, or five-year adjustment periods). New Century reported that these prepayment curve and default estimates resulted in weighted average lives of the loans in the securitization trusts of between 2.29 to 2.60 years for New Century's adjustable-rate securities and 2.33 to 3.54 years for its fixed-rate securities as of December 31, 2005.
- As of December 31, 2005, New Century estimated that average cumulative losses, as a percentage of the original principal balance of the mortgage loans in the off-balance sheet securitization trusts, were between 1.75% and 4.86% for adjustable-

[382] Another, more detailed description of New Century's procedures for valuing its residual interests appeared in documentation prepared by Ernst & Young in connection with the work it performed for the Company to meet its obligations under Sarbanes-Oxley. As discussed below, the fact that New Century had not previously and independently created its own manuals and descriptions to explain these policies or procedures raises serious internal control issues. The Company did not maintain a manual or internal document that described how the models worked. Warren Licata, who had primary responsibility within New Century for the residual interest valuation models, vaguely recalled that there was a discussion at some point that the Company should have policies and procedures in place explaining the models, but they "never got to it."

rate securities and between 1.45% and 5.30% for fixed-rate securities. According to the Company, these estimates were based on historical loss data for the loans, the specific characteristics of the loans, and the general economic environment. New Century explained that, while the range of estimated cumulative pool losses was fairly broad, the weighted average cumulative pool loss estimate for the entire portfolio of residual assets was 3.72% at December 31, 2005 and 3.87% at December 31, 2004.

- During 2005, the Company modified certain assumptions based upon actual performance and made minor adjustments to certain other assumptions, resulting in a $10 million downward adjustment in the fair value of its residual interests, including a hurricane loss provision of $2.6 million, for the year.[383]

3. Development and Operation of New Century's Residual Interest Valuation Models

a. In New Century's Early Years

Several people played key roles in creating and developing New Century's models for valuing residuals. The initial models were developed on Microsoft Excel spreadsheets by John Kontoulis, who was the Company's original head of the Secondary Marketing Department, in 1997 or 1998.

Ed Gotschall and Patrick Flanagan both played roles in the development of New Century's early residual interest models. Flanagan relied in part on expertise he had acquired dealing with securitizations at Bank One. Gotschall remained involved with the residual interest valuation models through the year 2000. According to Flanagan, as securitizations became more sophisticated, the models needed to be revised and others in the Secondary Marketing Department did the actual work in creating new models, but Flanagan told us that he remained very involved in the details of the models until he left New Century in 2005.

b. Major Problem with New Century's Residual Interest Valuations in 2000

As discussed previously, in the early years of New Century, its residual interests in off-balance sheet securitizations represented a large portion of its balance sheet assets. In 2000, New Century had to write down the value of its residual interests by nearly $70 million, which caused the Company to record its first loss. Patti Dodge attributed the write-down to the fact that

[383] New Century 2005 Form 10-K, Note (j), *Residual Interests in Securitizations.*

the Company's residual interest valuation models had used a CPR assumption that proved to be lower than actual prepayment experience.[384]

The Company's 2000 Form 10-K specified that the large write-down in New Century's residual interest values was due to a wider range of factors, including:

- Increases in interest rates that reduced the excess spread cash flow in the adjustable-rate securities;
- An increase of 1% in the discount rate assumption;
- A clean-up call being exercised for one securitization; and
- Increases in CPR and loss assumptions due to differences in actual versus projected results.[385]

According to documents reviewed by the Examiner, KPMG identified an inaccurate calculation in New Century's models used to value its residual interests. Apparently, until this time, New Century had not been evaluating actual results of its residual interests against the Company's projections and, therefore, had not been adjusting the models' assumptions properly.

The large write-down in residual interest valuation in 2000 may have had more than a short-term effect. According to Dodge, one reason why New Century decided, in or about 2002 or 2003, to reduce the relative size of the residual interests on its balance sheet was because of the difficulty of valuing those assets. Terry Theologides agreed that there was frequent discussion about the valuation of residual interests when they constituted a relatively big part of New Century's balance sheet, but that there were fewer such discussions when the Company stopped doing as many off-balance sheet securitizations, after New Century converted to REIT status, and residual interests receded in terms of their relative share of New Century's assets.

c. Development and Operation of New Century's Residual Interest Valuation Models Between 2000 and Early 2006.

In or about 2000 or 2001, after being hired by New Century as an analyst in August 1998, Warren Licata was asked by Gotschall to work on the Company's residual interest valuation models. Although Licata may have reported to Gotschall at the time, once he was transferred to the Secondary Marketing Department, the Secondary Marketing Department took full responsibility for fine-tuning and operating the residual interest valuation models.

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[384] Scott Carnahan was the KPMG audit partner on the New Century engagement for the 1996 to 1999 audits. Pat Kinsella assumed this role for the 2000 to 2004 audits. It is not clear whether this change in audit partners had any role in the discovery of the problems with New Century's residual interest valuations in 2000.

[385] 2000 Form 10-K at pp. 16-17.

Licata, who became a Senior Vice President of Secondary Marketing, had an MBA from California State University at Fullerton and seemed to have a good understanding of the issues related to residual interest valuation. Licata said that, when he first began working on residual interests, he ran the residual interest valuation models, determined and changed their assumptions, and assisted Gotschall in the process of deciding when residual interest valuations should be written down.

Over time, Licata and a "model" team within the Secondary Marketing Department rewrote and "changed the mathematics" in New Century's residual interest valuation models so that they would more closely track prospectus language for the relevant off-balance sheet securitization trusts, would be easier to update, and would rely upon "more practical" techniques. Although Licata's models continued to rely upon Excel spreadsheets, they were considered to be an improvement over previous models used by New Century (which were too "high-level" and inaccurate). Licata also thought it was difficult to track changes made to the models he had inherited. Licata's models principally relied upon estimates of prepayment rates and loan defaults, because either event would reduce future cash flows and thereby affect a residual interest's valuation.

Licata and his team developed new models for all of the Company's early securitizations deals (*i.e.*, from those done as early as 1997) and, until John Hatch took over the modeling process in 2004, created new models as new off-balance sheet securitizations were closed. New Century's securitization model for each transaction was in a Microsoft Excel file that had multiple spreadsheets. To create a new model, a senior analyst in the Secondary Marketing Department entered the structure of the deal into a model template, based on "waterfall" payment rules and other factors specified in the Prospectus Supplement for that deal and/or the relevant Pooling and Servicing Agreement. Because loan-level detail was too cumbersome to be modeled individually within the Excel spreadsheet, the senior analyst took the loan-level data from the mortgage loan collateral file and segregated those data into "Rep Lines."[386] The residual interest valuation models often had "collateral side" calculations (for cash flow payments to the securitization trustee) and "investor side" calculations (for amounts owed to investors). Each model had the same functionality and types of assumptions. Model structures changed and

[386] *Id.*

became more complex over time. According to Flanagan, the models became more accurate as New Century learned more about how the securitization structures worked.

The prepayment and loss assumptions in the models were determined internally by Licata and others in the Secondary Marketing Department based on their analysis of historical data collected by New Century and, to a lesser extent, market trends. New Century applied the same sets of prepayment and loss curve assumptions in all valuation models by vintage and collateral type. Prepayment and loss assumptions were based on fairly stable baseline assumptions, but could vary by deal based on collateral specific criteria. All changes to underlying assumptions from the previous securitization and the reasons for such changes were supposed to be documented in the final closing memorandum for each new securitization, but we have never seen such documentation.

Each residual interest valuation model relied upon forward LIBOR interest rates, both to determine the "pass-through" payments to which senior investors in the trusts were entitled but also to estimate the payments due from mortgage loan borrowers whose rates fluctuated with prevailing interest rates. These LIBOR rates and changes in the underlying loan collateral pool (*e.g.*, information about unpaid principal balances and actual delinquencies) were updated by the senior analyst within the Secondary Marketing Department based upon information received from Citigroup and the securitization trustee. A senior analyst within the Secondary Marketing Department was supposed to conduct a "back test" to compare the cash flows previously projected by New Century's models for each securitization to the actual cash flows received from the trustee. Licata was supposed to review the results of each back test quarterly to determine whether changes should be made to the models' cash flow assumptions.

These quarterly back tests were supposed to help New Century decide whether to update the models' assumptions regarding prepayment rates and loss experience. It appears that changes to model assumptions were not even considered unless Licata decided, based on his own knowledge and experience, that such changes were necessary. Licata acknowledged that he played a role in revising, reevaluating or modifying the assumptions every quarter. After receiving a set of data, Licata (and later other employees) would "roll" the models to the current point in time and true up the models so that the bond balances were accurate and tied out to the securitization trustee's statements. Licata then would modify the models for prepayment speeds and determine whether the deals were tracking as the Company had assumed. If the deals were

tracking properly, Licata would leave the models as is. If the deals were not tracking properly, Licata would determine what changes needed to be made to the models and would make them. According to Licata, there are times the models would be "hard-coded," *i.e.*, the mathematical routines in the models would be overridden, in order to force the models to produce results that matched the cash flows reported by the securitization trustees.

According to Licata, he wanted to observe at least six to nine months of data in order to determine if there was a "trend" suggesting that actual prepayment rates and loss curves were varying significantly from what had previously been forecast and, as a result, that one or more model assumptions should be changed. He considered three months of data too short a period of time to determine a "trend," but insisted that after six or nine months he would acknowledge and respond to a trend in the data.

When Licata (or later Hatch) determined that a change to a model's assumptions was necessary or appropriate, one of them would notify New Century's Accounting Department, Karl Weiss (to whom Licata reported in the Secondary Marketing Department) and New Century's Executive Management. According to Licata, after he had discussed a model assumption change with Kevin Cloyd and obtained his approval, the change would also be presented to a Management-level committee, *e.g.*, the Securitization Committee, the REIT Committee or the Asset and Liability Committee ("ALCO") Committee. Licata said that either he or Cloyd would present the proposed changes in assumptions to the relevant committee along with memoranda, charts and analyses explaining the change.[387] According to the SOX narrative of the residual interest valuation process prepared by Ernst & Young, model assumptions were not updated unless and until they were discussed and approved by Senior Management. It is not clear how often these approvals were sought or given.

Matt Mullins was hired by Licata in May 2002 to help run the securitization models that Licata had developed. As a senior analyst in the Secondary Marketing Department, Mullins was responsible, through the fourth quarter of 2005, for updating the data fed into the models.[388]

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[387] Licata also recalled that he, Cloyd and others provided information regarding residual interest valuations to New Century's Board of Directors or one of its committees, although no one has suggested that the Board or its committee played any role in deciding whether prepayment or loss assumptions in the residual interest valuation models should be changed.

[388] Mullins has a bachelor's degree in finance and a self-taught "technical background" in working with databases. Prior to joining New Century, Mullins had worked for several other mortgage companies on the production side. He did not have any experience in secondary marketing, securitizations, or hedging prior to joining New Century.

Mullins shadowed Licata for approximately one year to learn how to perform his initial responsibilities. Mullins later assumed responsibility for performing these tasks himself and then transitioned several of these tasks, over time, to Ron Brown, Henry Opinion and John Hatch.

Mullins' responsibilities included loading data from the trustee statements into the securitization models, rolling the models forward (*i.e.*, updating the models on a monthly basis with actual data), reconciling any discrepancies between the models and the trustee statements, reviewing and updating (if necessary) the assumptions set forth in the models, and generating various reports on the value of the Company's residual interests and other outputs from the models. Since each securitization had its own model, Mullins had to repeat these tasks for each of many residual interest models. When Mullins began at New Century in 2002, there were approximately 12 such models. When he left the Secondary Marketing Department in 2006, there were more than 30.[389]

Brown joined Licata's group in 2003 to load the data transmitted by the securitization trustees into the Secondary Marketing Department's database. Colleagues complained that Brown's poor performance of this task caused problems for senior analysts who had to roll forward the models in short periods of time after Brown loaded the data.

Opinion joined Licata's group from the production side of New Century some time in late-2005 or early 2006.[390] At that point, he reported directly to Licata. His first three months involved shadowing Mullins, trying to understand how things worked in the Secondary Marketing Department and learning how to roll the residual interest models forward. Eventually Opinion took over that role. Opinion initially reported to Licata, but as Licata started bringing on more people, and because there were too many people for Licata to supervise directly, Opinion started reporting directly to Mullins. Opinion helped Mullins with the residual valuations for the fourth quarter of 2005 and the first quarter of 2006, then worked under Hatch beginning in the second quarter of 2006 when Mullins left and Hatch took over from Mullins the primary responsibility for the residual interest valuation models. Opinion's primary

[389] Mullins left Licata's group to work for Mary Malloy in the newly-formed hedging group within the Secondary Marketing Department in approximately March or April of 2006, and eventually left New Century on May 31, 2007.

[390] Opinion started with New Century in August 2004, working on the wholesale side of the Company, where he reported to Karen Hernandez. Before that Opinion had been an advisor for UBS for a year and at Ditech for a year. He was two years out of school when he started at New Century.

responsibility was to roll forward the residual interest valuation models on a quarterly basis and to reconcile differences between New Century's data and the data from the securitization trustee.

According to Opinion, no one even looked at the assumptions in the residual interest valuation models until actual performance data from the securitization trustee were loaded into the models and the models were rolled forward. Opinion did not analyze the baseline assumptions in the models in the fourth quarter of 2005 or the first quarter of 2006, but only provided information to superiors, such as Licata, who, from his perspective, made decisions about how those assumptions should be changed, if at all.

d. The Valuation Models Built and Operated by John Hatch

After Hatch joined New Century in November 2003, he built valuation models for all new securitization deals originated in and after 2004. Hatch was highly regarded for his analytic and technical skills. Hatch's models were more sophisticated than Licata's models because he had a better understanding about how models should be used to value residual interests. He was also willing to question how New Century's models were performing those valuations and was not shy about suggesting changes to those models. According to Licata, New Century needed Hatch to rewrite New Century's models because the securitizations in which New Century was engaging had become more complex.

Like Licata, Hatch built Excel-based models that were designed to determine the net present value of projected cash flows over the life of each deal. Hatch created his Excel model template by looking at the previous models developed by Licata and adding features to expedite the valuation process and to capture additional loan-level fields that were not available in Licata's model by, for example, adding rep lines, breaking out collateral groups, modeling all bonds in a deal (not just different tranches), and updating the mathematics of the models. Hatch said that he did not create any models to value off-balance sheet CE securitizations and that the only off-balance sheet securitizations that he "modeled" (2005-A, 2005-B, 2005-C and 2005-D) were NIMS transactions. Hatch said that NIMS deals were "easy" to model because they required just one-page spreadsheets. He also said there was no difference between the models for off-balance sheet "residual" deals and OBS deals.

Hatch did not model the residual interests in the pre-2003 off-balance sheet securitizations and did not change the models for those deals that had been developed by Licata. Hatch said that he discussed "re-modeling" those deals with Licata after Hatch joined New

Century, but Licata determined it was not worth the time and effort because of the "seasoning" of those deals. According to Licata, it would have been "cost-prohibitive" to re-model the older securitizations and he did not believe better models would "dramatically" change the valuations of those older residual interests.

Hatch's initial responsibility was to create models for new securitizations. He was not responsible for rolling those models forward or for otherwise updating those models to determine the value of residuals after inception of the securitization. The other members of Licata's team (Mullins, Brown and Opinion) were responsible for those tasks. In late 2005 or early 2006, Hatch became responsible for portfolio reporting within the Secondary Marketing Department, taking over that responsibility from Mullins when Mullins left to join Mary Malloy's hedging team. In this capacity, Hatch had to report to Licata on the value of all securitizations. But even then Hatch did not undertake a detailed evaluation of the pre-2003 models or roll any of these models forward, because that was the responsibility of Opinion, and later Matt Walder, who had become responsible for data loading.

Hatch had discussions with Mullins prior to the time that Mullins transferred the responsibility for portfolio reporting to Hatch. According to Hatch, he did not intend to perform those responsibilities differently than Mullins had nor did anyone at the time perceive a change in the way Hatch performed those responsibilities. Hatch has acknowledged that he may have scrutinized the post-2003 residual interest models more thoroughly because he created them and that he was not familiar with all the assumptions in Licata's models for the pre-2003 securitizations. Neither Hatch nor Mullins recalls any discussion, when Hatch assumed Mullins' responsibilities, of the way that assumptions in the pre-2003 residual interest models had been updated by Licata and Mullins. It was not until early 2007 (when Hatch was asked to go back and review the assumption changes to the pre-2003 models that occurred when Mullins was in charge of portfolio reporting) that Hatch learned that Licata and Mullins had changed assumptions for the pre-2003 models more frequently before Mullins left and Hatch became responsible for portfolio reporting. Despite overwhelming evidence that this is so, Licata has denied that the Secondary Marketing Department changed the frequency with which it updated assumptions in the pre-2003 models during 2006 or its practices in that regard.

e. Supervision of the Residual Interest Valuation Process Within Secondary Marketing

When Licata moved to the Secondary Marketing Department, he originally reported to Cloyd, who reported to Flanagan. After Flanagan left New Century in 2005 and Cloyd became the Executive Vice President for Secondary Marketing, Weiss was hired as a Senior Vice President of Secondary Marketing to manage Licata and other vice presidents in the Secondary Marketing Department.

Weiss never played much of a role in overseeing Licata's work on residual interest valuation. Licata and Hatch worked directly with Cloyd on residual valuation issues, and Weiss never inserted himself into the process for valuing residual interests, except, perhaps, to edit for style purposes some PowerPoint presentations dealing with residual interest valuations. Weiss said he did not ask more questions of Licata about residual interest valuations because he believed in "horizontal management" and did not care if Licata went straight to Cloyd when necessary because the residual interest valuation process existed before Weiss arrived at New Century, it was not something with which he was familiar, he had no plans to change it, and Cloyd knew the subprime mortgage market and the residual interest valuations better than Weiss.

When the residual interest valuation models were "rolled forward" each quarter, Licata and Cloyd would engage in dialogues about whether changes should be made in the models' assumptions relating to cumulative losses and prepayment speeds. Because of Cloyd's expanding range of responsibilities after Flanagan left New Century at the end of 2005, Cloyd began to focus more on corporate management issues and Licata's portfolio was expanded to include whole loan sales. These factors may have led to greater autonomy in the securitization modeling and valuation group, although the personnel in the group continued to report to Licata.

f. Communication of Information About Residual Interest Valuations from Secondary Marketing to the Accounting Department and Others

i. Secondary Marketing's residual asset valuation binders and other reports

The Secondary Marketing Department provided KPMG and New Century's Senior Management with Residual Asset Valuation binders on a quarterly basis. These binders contained the documentation that supported the Secondary Marketing Department's present

value calculations of the residual interests that the Accounting Department would book in New Century's general ledger.[391]

These Residual Asset Valuation binders included eight sets of documents:

a. A narrative summary of each quarter's CE off-balance sheet securitizations and NIMS securitizations;

b. A numerical summary of the net present value, cumulative losses, and other values associated with those securitizations;

c. Projected LIBOR curves, since the one-month LIBOR was used in calculating bond payments to investors in the securitizations and the six-month LIBOR was used for calculating interest payments on adjustable-rate mortgages ("ARMs") that may have been part of the underlying collateral for the securitizations;

d. An analysis of hedging performance against the interest rate of one-month LIBOR;

e. A CPR chart that included one-month data annualized, a loss curve chart that showed the loss curve over the life of the loans, and a CPR chart that included data from the start of the loans;

f. A loss analysis, which was used primarily by KPMG and the Accounting Department;

g. An analysis of triggers, which described the different types of triggers and evaluated how close New Century was to the trigger threshold (*i.e.*, to "popping" a trigger) that would require action by New Century; and

h. The amounts New Century was making or losing on the securitizations based on modeled versus. actual cash flows. At times, New Century may have had to transfer additional assets into an OC account trust to maintain sufficient credit enhancement for investors. Mullins stated that "lots of eyes were looking" at this section of the residual asset valuation report.

Secondary Marketing also provided ad hoc reports on residual interest valuations upon request. Some reports were a comparison of actual data to projected data based on certain assumptions.[392] Other reports were analyses of various "what if" scenarios requested by the Securitization Committee or other Management officials, *e.g.*, an analysis of the impact on the securitizations if interest rates rose and New Century slowed down the CPR. The Secondary

[391] The sheer volume of each binder and certain reports in the binder were designed in part to convince KPMG and New Century's Accounting Department that the residual interest calculation was supported by sufficient documentation. According to Mullins, the running joke within Secondary Marketing was that "the binder felt like an A."

[392] The Secondary Marketing Department also reported on the cash flows received by New Century from the securitizations.

Marketing Department's modeling team frequently ran up to 12 different assumption scenarios through the models at the end of an annual period, which often put time pressure on the team to meet deadlines.

According to Licata, these alternative residual interest calculations at the end of particular quarters were for "sensitivity analyses" that helped the Accounting Department determine the "matrix value" of the residual interest assets and breakpoints for footnote disclosures in New Century's Forms 10-K.[393] Particularly in late-2006, the Secondary Marketing Department was asked to measure changes in value that would occur under different scenarios for purposes of the Project Kettlebell negotiations and to understand the impact on fourth-quarter 2006 financials of various changes in residual interest valuation methodology.

Mullins said he was not involved in any of the decisions to run alternative scenarios through New Century's residual interest valuation models and does not know why he was asked to do so. The various scenarios were not kept secret, and Mullins did not believe they were requested to help New Century hit earnings targets. Licata also denied that these alternative calculations were intended to help New Century reach earnings targets, although he conceded that changes in residual interest valuations could have an impact on quarterly earnings and that it would be "simple" to determine the impact on earnings per share of changes in different assumptions in the residual interest valuation models. Licata does not recall ever being asked to make such a calculation.

ii. Accounting's use of information received from Secondary Marketing

Residual interest valuations were among the critical accounting issues that were reviewed on a quarterly basis for financial statement purposes. The Finance and Accounting Department relied on Secondary Marketing Department personnel to supply those valuations. Each quarter, about a week in advance of KPMG's review, Dave Kenneally would receive a standard reporting package from the Secondary Marketing Department that contained the fair values computed by the residual interest models and summary sheets that described the assumptions used by models (*e.g.*, regarding prepayment rates, cumulative loss rates and discount rates). Kenneally characterized this as a "mechanical" process of transmitting data that allowed the Finance and

[393] An example of one such footnote disclosure can be found in New Century's Form 10-K for 2005 at page F-29.

Accounting Department to record various journal entries. Kenneally did not check the inputs into the residual interest valuation models.

Kenneally acknowledged having regular discussions with the Secondary Marketing Department regarding the fair value of residual interests, primarily so the Secondary Marketing Department could explain the reason for any material variances between their residual valuation calculations and certain hedges. During 2006, the Finance and Accounting Department received e-mails and documents from the Secondary Marketing Department on a regular basis. Sometimes that information was prepared at the request of other individuals and copied to the Finance and Accounting Department. Other times the Secondary Marketing Department would supply the Finance and Accounting Department with more information or analyses than they requested.

According to Kenneally, at least as of 2005, the Secondary Marketing Department shared its residual interest valuations with ALCO and the Finance Committee, and the Accounting Department would book those valuations only after they had been approved by the ALCO Committee and the Finance Committee.[394] Although Donna Walker could not recall a specific instance in which she was asked to make an adjustment to residual interest numbers she received from the Secondary Marketing Department , she stated that she might have been asked to make such an adjustment by Kenneally, noting that a residual interest is a "very intricate model to run" and that it generally goes through a few revisions. Walker prepared an internal CFO report on a monthly basis, which contained a residual interest page supplied by the Secondary Marketing Department. The internal CFO reports were posted on Encompass, a program that was available on the desktops of certain New Century employees.

g. Review of Residual Interest Valuations by Senior Management Outside of Secondary Marketing

The investigation revealed a general lack of understanding and confusion within Senior Management about who was responsible for the residual interest valuation process in general and certain aspects of that process in particular. For the most part, New Century's Senior Management and executives in parts of the Company outside of the Secondary Marketing Department and the Finance and Accounting Department became aware of residual interest

[394] *See* Section VI.B.3.i. below for a discussion of ALCO and its role in reviewing residual interest valuations.

valuation issues, if at all, through their participation in various Management-level committees described below.

h. The Securitization Committee's Review of the Company's Residual Interest Valuation Process

The Securitization Committee was a Management-level committee that was created to review the structure, pricing, valuation and performance of previous loan securitizations and to discuss how to improve the securitization of new loans. It is not clear when the Securitization Committee was first created, but minutes for the Securitization Committee go back as far as 2002. It appears that a decision to securitize loans was not taken to New Century's Board of Directors until after consideration by the Securitization Committee.

At various point in time, the members of the Securitization Committee consisted of key members of Senior Management, people within the Secondary Marketing Department who were involved in modeling and execution of securitizations, and representatives from the Finance and Accounting Department, including Robert Cole, Brad Morrice, Gotschall, Flanagan, Dodge, Cloyd, Kenneally, Jeff Goldberg, Licata, Rod Colombi,[395] Yury Pyatigorsky,[396] Paul Tuan, and Ralph Flick. Representatives of KPMG regularly attended meetings of the Securitization Committee.

When interviewed, members of the Securitization Committee had, at best, only vague recollections of the procedures and policies it used to review the Secondary Marketing Department's residual interest valuation models and to check their results, although Gotschall and Flanagan confirmed that the committee performed such reviews on a quarterly basis. Morrice, who said he was an ex-officio member of the Securitization Committee, vaguely recalled that the committee may have reviewed some analytics related to the assumptions used in the residual interest valuation models. Although minutes were kept, many were not located and it is not clear how consistently they were prepared.

Flanagan said the Securitization Committee would decide what information to present to the Company's auditors, based on presentations by the Secondary Marketing Department and Accounting Department. According to Flanagan, there were many "moving parts" when it came

[395] Executive Vice President of Corporate Finance.

[396] Pyatigorsky was an analyst who reported to Colombi. He may not have been an official member of the Securitization Committee, but the Committee probably relied on his expertise during the meetings because he modeled the cash flows for the entire Company.

to valuing residual interests, such as forecasting borrower behavior and the interest rate environment, and the valuation of residuals was not an exact science. According to Gotschall and Flanagan, there was a wide range of opinions from everyone (accountants, Board members and Management) on these issues, and members of the Securitization Committee often asked questions and requested changes before approving the models or their results.

i. The Role of the REIT Investment and ALCO Committees, as Successors to the Securitization Committee

The REIT Investment Committee replaced the Securitization Committee in or about 2004. The members of the committee appear to have remained largely the same, and it appears that its review of residual interest valuations was similar to the review previously conducted by the Securitization Committee.

Shortly after Lou Garday was hired as New Century's tax director in December 2004,[397] the REIT Committee was renamed ALCO, which became responsible for reviewing all investments and all risk management. Garday was made the chair of ALCO in or about mid-2005. According to Kenneally, the Secondary Marketing Department shared its residual interest valuations with ALCO and the Finance Committee, and the Accounting Department would not book those valuations until they were approved by ALCO and the Finance Committee.

The REIT Committee and ALCO were subcommittees of the Finance Committee, which was chaired by the Company's CFO. The Finance Committee involved all senior leadership in Company, who also sat on ALCO. According to Garday, any decision by ALCO was "kicked up" to the Finance Committee, which in turn could kick the issue up to the Executive Management Committee ("EMC").[398]

The three founders of New Century (Gotschall, Cole and Morrice) were honorary ex-officio members of ALCO.[399] The voting members of ALCO included one person from each relevant area of the Company: Licata (Secondary Marketing), Cloyd (Capital Markets), Garday (tax), Taj Bindra (CFO), Lenice Johnson (Credit), and Weiss. Garday said that the heads of these areas met to focus on investments and assets and liabilities. The committee had a standing

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[397] The Company hired Garday to be the Company's tax director and REIT expert.

[398] The EMC was also known internally as the "G-7," and senior vice presidents of the Company were called the "One-Down Level."

[399] Garday said he did not recall seeing Gotschall at an ALCO meeting, but that he did not think that Morrice missed an ALCO meeting. Garday said that Cole was very active in ALCO meetings until maybe the October 2006 meeting. He did not remember Cole missing a meeting.

meeting once each month. ALCO meetings covered a number of different issues, including the tax consequences of various transactions. One set of discussions – apparently among Dodge, Kenneally, and Goldberg – had to do with what discount rate should be used to value residual interests.[400]

Garday said that, except for the discount rate assumption, the assumptions the Secondary Marketing Department used and changes in those assumptions did not go through ALCO, *i.e.*, that Licata and his modeling team did not bring proposed changes to the prepayment and loss assumptions in their models to ALCO. According to Garday, ALCO's agenda was largely set by SOX and tax requirements, which demanded an orderly and well documented review of certain key decisions. The assumptions used in the residual interest valuation models did not fall into that category, and the "section heads" and "generalists" on ALCO did not "drill down" to a level of detail that would have included residual interest assumptions, which, Garday believed, were decided by Licata and the Controller's office.

Licata, who often attended ALCO meetings and made presentations on residual interest valuations, agreed that the members of ALCO did not focus on the details of the residual interest valuations. Licata put together residual interest valuation summaries for ALCO, which would vote to "approve the numbers." According to Licata, ALCO would also have been the proper committee to approach for permission to collapse the pre-2003 off-balance sheet securitization trusts, but Licata never did so in or before 2006.[401]

j. Review of Residual Interest Information in Connection with Preparation of SEC Filings and SOX Certifications

The Legal Department usually created "Time & Responsibility" ("T & R") schedules each quarter in connection with the preparation of public filings. Reviewing and updating assumptions about residual interests were specifically referenced in each T & R schedule (the only accounting function expressly set forth there).[402] The Legal Department did not know what steps members of the Secondary Marketing Department took to meet their responsibilities as to

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[400] *See* Section VI.B.7.b. for a more detailed discussion of the debate that occurred over discount rate assumptions.

[401] *See* Section VI.B.7.d. below for a discussion of the significance of "collapsing" off-balance sheet securitization trusts.

[402] Dodge speculated that this was because of the relative significance of residual interests on the Company's balance sheet in its early years. *See* Section VI.B.3.b. above.

residual interests on the T & R schedules or how KPMG performed the testing that was also described in those schedules.

To satisfy requirements of Sarbanes-Oxley, the Legal Department prepared and circulated SOX certifications and mini-certifications every quarter and tracked their execution. One of those mini-certifications, executed by Cloyd, included specific certifications regarding residual interest valuation, along with other subjects. Cloyd was asked to sign these representations on behalf of Secondary Marketing. The Legal Department did not know what steps Cloyd or his staff took in verifying the information he was certifying.

k. Review of Residual Interest Valuations by New Century's Board of Directors and the Audit Committee

i. The Board of Directors

Residual interest valuations were a topic of discussion at every Board meeting. From the perspective of Board members, residual values were determined by using complex calculations that depended upon a number of variables. According to Fred Forster, New Century's lead Director (and current Chairman), residuals were considered to be volatile assets because of the wide range of uncertainties related to these variables, which often relied upon estimates and assumptions.

Forster said that the Board relied on KPMG to provide assurances that the Company's financial information was adequately stated, which KPMG did in presentations to the Audit Committee. According to Forster, the Board, through the Audit Committee, hired KPMG to review the Company's residual interest calculations and to confirm that the calculations were appropriate. Forster expected that KPMG would review the residual interest calculations assumption by assumption and discuss those assumptions with Company representatives until both sides were comfortable with the result. Forster recalled that New Century had been required to "write down" its residual interests several years before (causing New Century to record a loss for the year in question) because KPMG had said that the number needed to be lower.[403] According to Forster, this insistence by KPMG had given the Board confidence in KPMG's review of the Company's residual interests.

According to Forster, by undertaking a detailed review of New Century's residual interest calculations and presenting a "consensus valuation" to the Board, KPMG "put their stamp" on

[403] *See* the discussion of this write-down in 2000 in Section VI.B.3.b. bove.

the Company's assumptions. Forster said that, although there were extensive discussions at Board or Audit Committee meetings about how the Company's residual interests were calculated, he and other Board members relied on KPMG to get a comfort level with the Company's residual interest valuations.

Forster said that New Century's residual interest values were important for a number of reasons, including their impact on earnings and how the marketplace perceived the Company. Forster explained that if the Company adjusted its residual interest balance, the market would likely question the Company's future product, thus driving down its share price.

ii. The Audit Committee

As part of its "very active" review of accounting and KPMG activities, members of the Audit Committee (particularly Rick Zona) would regularly ask pointed questions of the CFO, the Controller, Secondary Marketing and KPMG regarding residual interests and the assumptions underlying the residual interest calculations.

According to Zona, the Audit Committee focused on risk areas and related accounting areas that required a great deal of judgment by New Century's Accounting Department. These focus areas were probably the same in the beginning and at the end of 2005, as well as during 2006, and included the valuation of residuals and related hedging. Zona said that, because their valuation was "highly judgmental," residual interests were discussed in depth by the Audit Committee, the Accounting Department and KPMG. Zona stated that the main issues of concern regarding residual interest valuation were the Company's choice of discount rate, its loss assumptions, and its prepayment assumptions, because these issues drive the valuation process.

Michael Sachs, the chair of the Audit Committee, explained that at least 50% of the Audit Committee meetings included an executive session with KPMG at which the topics included, among others, how KPMG had reviewed the Company's residuals and whether they were valued correctly. Sachs was unable to recall any specific concerns raised by KPMG at the executive sessions and was sure that KPMG never raised any items that required Audit Committee action.

The Audit Committee's minutes confirm that residual interest valuation issues were frequently discussed during 2006 and that Mark Kim or John Donovan repeatedly represented to the Audit Committee that KPMG had reviewed "Management's judgments and estimates relating to the corporation's . . . valuation of residual interests in securitizations," that KPMG had found

those estimates were "reasonably stated," that "KPMG had not discovered any material differences in these estimates," and that KPMG had evaluated "key factors and assumptions."

4. KPMG's Role with Regard to New Century's Residual Interests

a. From the Perspective of New Century's Board and Management

As indicated above, the New Century Board of Directors and Audit Committee looked to KPMG to give it comfort with regard to the Company's residual interest valuations. Until 2007, KPMG never suggested to the Board or the Audit Committee that New Century's residual interest valuations may have been materially misstated on New Century's financial statements.

Until at least 2002, residual interests represented a significant portion of the Company's total assets.[404] Because of the historic importance of the Company's residual interests, KPMG focused more on this issue than on other accounting issues during much of the Company's early history. According to Dodge and Cloyd, after New Century decided to reduce the relative size of its residual interests, KPMG focused more attention on the allowance for loan losses and hedge accounting than on residual interests.

Dodge and Kenneally would meet with KPMG every quarter for at least an hour prior to Audit Committee meetings to discuss the valuation of the Company's residual interests and other relevant accounting issues. During those discussions they would review with the KPMG audit partner the large Residual Interest Valuation binders prepared by the Secondary Marketing Department, which contained historical experience for each securitization and vintage data.[405]

Kenneally dealt more frequently than Dodge with KPMG during 2005 and 2006. In addition to discussing residual interest issues with KPMG in connection with KPMG's period-end "fair value" reviews, Kenneally typically reviewed and provided comments on drafts of any presentation that KPMG would make to the Audit Committee or Board a day or two in advance of the meeting. Kenneally and Donovan would also talk about how to respond to questions raised about New Century's residual interest valuations by KPMG's Structured Finance Group ("SFG").[406]

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[404] *See* Sections VI.B.3.b. and VI.B.3.d. above.

[405] *See* Section VI.B.3.f.i. for a discussion of the Residual Asset Valuation binders that the Secondary Marketing Department prepared for the Accounting Department and KPMG.

[406] *See* Section VI.B.4.d. for a discussion of the audit assistance provided by the SFG.

The independent Directors whom we interviewed repeatedly told us that they received what they regarded as comfort from KPMG that there were no significant problems with New Century's residual interest valuations. Members of Senior Management, including Morrice, Dodge and Cloyd, generally repeated this view. Senior Management and the independent Directors took comfort from the fact that KPMG tested New Century's models on a regular basis, even though they seemed not to know very much about the nature or results of those tests or held what appeared to be incorrect understandings of what KPMG had done.[407]

More junior members of the Secondary Marketing Department and of the Finance and Accounting Department, however, recalled earlier signals from KPMG that they had concerns about New Century's residual interest valuation models, above and beyond the discount rate assumptions that received the most discussion. For instance, Hatch recalled hearing from KPMG engagement team members during 2006 that New Century's models had shortcomings that were in increasing need of an overhaul. Tony Sanchez recalled that, during the second quarter of 2006, Kim made an "offhand comment" to him suggesting that KPMG was becoming more concerned about New Century's residual interest valuations and that residual interests were becoming a "hot button" topic. Sanchez also learned that Kenneally had become aware that Scott Carnahan "did not think [the residual interest calculation] was right." As discussed below, KPMG's expressions of concern became more pointed in early 2007.

While some New Century employees were concerned about KPMG's increasing criticisms of New Century's residual interest valuation models, Licata was not. Licata became aware of some of KPMG's concerns because he participated in the KPMG's period-end meetings or was otherwise made aware of KPMG's concerns. But according to one subordinate, Licata typically dismissed KPMG's concerns as "immaterial" and resisted changes to New Century's residual interest valuation methodology on the basis that his work had always "passed audit."

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[407] Flanagan recalled that around 2002 or 2003, KPMG was hired to do a complete audit of New Century's residual interest valuation models and that only minor errors were discovered during that process. But Flanagan incorrectly believed that this "audit" of New Century's models was during a time when Carnahan was the KPMG audit partner for New Century. In fact, Carnahan was the KPMG audit partner for New Century for the 1996 to 1999 audits and Kinsella was the audit partner for the 2000 to 2004 audits. Furthermore, Flanagan recalled that, prior to KPMG, the Berkshire Group did some work on New Century's models. No one else recalls any such work nor have we been able to find any documents regarding work by the Berkshire Group on New Century's residual interest valuation models.

b. KPMG's Audit Teams and Their Work on Residual Interest Issues

In 2005 and 2006, the relevant KPMG engagement team consisted of Donovan, Kim, Ryan Beckstrom and other associates of KPMG. Marc Macaulay was the concurring partner for the New Century audit. The following paragraphs describe the key KPMG personnel for purposes of their review and audit of residual interest valuations.

i. John Donovan

Donovan became the KPMG audit partner for New Century after New Century's 2004 Form 10-K was filed in early 2005. Donovan appeared to have, at best, a general understanding of New Century's residual interest valuation models. He understood that New Century accounted for its residual interests by "estimating cash flows and then discounting them at a rate they believed was market-commensurate." Donovan knew that New Century used its own internally-developed models to value its residual interests, but did not know who at New Century had created those models. Donovan was aware that each securitization by New Century required the development of a new model, but he could not recall how many models New Century had developed during the relevant time period.

Donovan acknowledged that, with respect to its 2006 quarterly reviews and 2005 annual audit, KPMG had concluded that New Century's residual interests were "fairly stated, when looking at the financial statements as a whole."[408] Donovan said he never had any concerns regarding New Century's models, though "there were some concerns raised during our audit of 2006, in the 2007 timeframe, regarding the models, how to audit them, and what was the appropriate discount rate." Donovan said KPMG never determined how accurate New Century's models were because "we never finished our work" with regard to the 2006 audit. According to Donovan, year-end 2006 was different from year-end 2005 simply because "the market had changed - things were different." Donovan also stated that, even now, based on the information he has, he still views New Century's residual interests for 2005 as "fairly stated."

ii. Mark Kim

Kim considers himself to be someone who knows how to value residual interests. He said that he had experience with residual interests at Encore and with other mortgage clients of

[408] Donovan explained that the phrase – "in the context of the financial statements as a whole" – reflects KPMG's policy of not opining on "individual balances and line items." Donovan confirmed that this determination involved questions of materiality.

KPMG. During his interviews with us, Kim provided a more sophisticated discussion than Donovan of what residuals are and how they are valued.

Kim told us that residual interests arise as a result of an off-balance sheet securitization and that they represent a stream of cash flows discounted to present value and retained as assets on the Company's books. Kim said there are several components to the valuation of residual interests, including prepayment speeds, projected losses from the collateral assets and interest rates that the collateral pools have as compared with what the bondholders were receiving. Kim said that each residual interest model relied upon a set of assumptions (including prepayment speeds, interest rates, and loss assumptions) and that there would be changes in those assumptions from time to time.

Kim could not recall which assumptions in New Century's residual interest models changed. Kim understood that when assumptions needed to be changed there would be a review by the Secondary Marketing Department, which would recommend changes in assumptions to New Century's Finance Committee for approval.[409] Kim's understanding was that if certain trends were clearly noticeable, *i.e.*, if they occurred over a long period of time, and were not just a "blip" in one quarter, the Secondary Marketing Department would recommend a change in assumptions.

Kim stated that, despite certain deficiencies identified during the audit and review processes, New Century's residual interest valuation models were reasonable in that the models yielded reasonable values, *i.e.*, that the output of the models was reasonable. According to Kim, KPMG would suggest changes to the models. The engagement team, including SFG, would meet with the Secondary Marketing Department and Kenneally and make a presentation regarding KPMG's suggested changes. According to Kim, residual interests were not that much of an issue during 2005, but became a more important issue in 2006 because of changes in the housing and mortgage markets.

iii. Ryan Beckstrom

Beckstrom first worked on New Century's audit in connection with the audit of the Company's 2004 year-end financials. He thereafter worked on the 2005 quarterly reviews for

[409] Kim said that, as part of the audit process, KPMG reviewed the minutes of the Finance Committee to see what was decided. Kim did not recall how often changes in assumptions were made, when they were made, or whether the Committee ever rejected suggested changes. The Examiner has not found any discussion of assumption changes in Finance Committee minutes.

New Century. As part of the 2005 quarterly review process, Beckstrom began working on residual interest issues, among others.

Beckstrom had, at most, a rudimentary understanding of residual interests.[410] Beckstrom had not worked on residual interests for any other company and did not have any experience evaluating other models for valuing residual interests. He understood that the purpose of New Century's models was to provide a value for the residual interests that the Company held. Beckstrom, however, did not completely understand the Company's residual interest models, he could not judge the level of sophistication of the models, and the procedures he performed in testing the models did not give him a basis for forming an opinion regarding the sufficiency or effectiveness of the models. Beckstrom did not have an impression regarding the models used to value 2005 securitizations as compared to the models used to value pre-2003 securitizations. Beckstrom said that the models were more complex than he was comfortable evaluating.

c. KPMG's Procedures for Reviewing New Century's Residual Interest Models

In general, KPMG engaged in the following procedures to evaluate New Century's residual interest models:

1. The engagement team performed data integrity testwork, by which it compared the data entered in the models with the trustee statements for the specific deal.
2. The engagement team performed a reasonableness test on the accretion income associated with the residual interest. Essentially, this was a test to compare estimates, which had been based on past performance, with actual results. In general, if those tests revealed actual results that differed by more than 5% from predicted results, further testwork was considered necessary.
3. The engagement team also reviewed information regarding prepayments and the losses associated with the residual interests.
4. The engagement team asked KPMG's SFG to test a sample of New Century's residual interest models.

More details about KPMG's audit procedures were set forth in the Residual Interest Valuation Conclusion Memoranda that KPMG would prepare in connection with each review and audit. As set forth in one such Memorandum:

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[410] Beckstrom's understanding was that a residual interest was the right to future benefit (in terms of future cash flows) to the Company as a result of a securitization transaction.

1. The engagement team reviewed any new securitization transaction that occurred to ensure that it was properly accounted for as a sale or a secured borrowing.

2. The engagement team also performed analytical reviews of fluctuations in models to compare estimates to actual results.

3. The engagement team looked at losses and loss percentages for each securitization.

4. The engagement team assessed the reasonableness of the discount rates the Company used in each model. The determination of a discount rate's reasonableness was based on whether the information available supported the Company's choice of discount rates.

5. Because, in certain key respects, the Company's residual interest models rested upon judgments, assumptions and/or expectations by Management concerning matters such as discount rates, expected losses, and prepayment rates, the KPMG engagement team tested Management judgments in those areas by reviewing and comparing actual performance to Management's past estimates. For example, KPMG would compare the amount that was estimated in the prior quarter to actual performance. (SFG was part of this review.)

6. When estimates of a key variable (*e.g.*, of prepayment rates) were incorrect over several quarters, the engagement team would review the estimates to determine whether there was a recurring problem with Management's estimates or whether the divergence between the estimates and actual results could be attributable to the fact that modeling is not an exact science.

Even when KPMG raised the "inherent risk" assessment for its audits of residual interest valuations from "moderate" for its 2004 and 2005 audits to "high" for its 2006 incomplete audit, the range of audit procedures planned by KPMG for those audits hardly changed.

One of KPMG's audit procedures was to review the assumptions used in New Century's models. The engagement team understood that each residual interest model had a set of assumptions and that there would be changes in those assumptions from time to time. Some of these assumptions concerned prepayment speeds, interest rates and loss assumptions.

d. Audit Assistance from KPMG's Structured Finance Group

In auditing New Century's residual interest valuations, KPMG's engagement team sought and received the assistance of its SFG. Donovan explained that the practice of involving the SFG in the process of reviewing New Century's residual interest valuations had been in place when he took over the New Century engagement, and he elected to retain it. Donovan said that

the engagement team had an "ongoing dialogue" with SFG. Both Donovan and Kim considered SFG to be part of the engagement team.

Kim indicated that SFG was involved every quarter in KPMG's work at New Century. Kim stated that, although memoranda from SFG stated that their assistance was requested by the engagement team on specific dates, it was understood that SFG would be an integral part of the team. Kim stated that SFG is regularly involved with most financial services audit engagements in the same fashion as it was with New Century, although Kim admitted that he had limited previous experience working with SFG at KPMG. Before his assignment to New Century, Beckstrom had not previously worked with SFG, although he has since worked with SFG.

Carnahan, the SFG partner who provided audit assistance for the New Century engagement in 2005 and 2006 had been the audit engagement partner for the 1996 to 1999 New Century audits and, as a result, should have had a good understanding of the Company and the risks associated with its valuation of residual interests. Carnahan told us that he had regular oral discussions with the audit partners regarding issues that SFG identified with respect to the residual interest valuations.

SFG provided different forms of assistance to the New Century engagement team:

First, SFG reviewed pool and servicing agreements to see if a securitization was a true sale.

Second, SFG would look at the specific numbers of each transaction to ensure that amounts were being recorded properly on New Century's books. As part of the proper recording, they would test the proceeds coming in.

Third, SFG would run the data New Century received from the securitization trustee through KPMG's own model to check the results produced by one or more New Century models.

According to Kim, SFG tested New Century's models for their mathematical accuracy and to determine whether the models were performing as intended, and it reviewed their inputs and outputs. Based on its industry knowledge and experience, SFG also provided advice regarding the reasonableness of assumptions in the models.

Kim understood that each securitization transaction had its own model and that there were about 15 or 20 different such models. Each quarter SFG would test a sample of models. Donovan stated that it was his practice to have SFG review one or two residual interest models each quarter and at year-end. KPMG selected the models to evaluate. In the first quarter of

2006, Donovan requested that certain of the 2005 models be reviewed. Beckstrom was asked to select the models at some point in 2006. He asked SFG to review models that had not been reviewed in the prior year. Kim suggested that they not review the same models each quarter and that the models be rotated for testing, so that over the course of a year, KPMG would have reviewed a number of the models from an audit standpoint. Kim could not recall the same model being selected for testing in successive periods. Debbie Biddle said that it was part of KPMG's audit strategy to test at least two models per quarter. Biddle told us that KPMG selected the models at random and attempted to choose new models as well as a cross section of older models.

Each quarter the engagement team would provide electronic copies of the selected models to SFG to review. Beckstrom did not know if SFG created its own models to test New Century's models, despite the clear indication in its audit-assist memos that KPMG "independently modeled" certain residual interest transactions. Carnahan told us that SFG used its own internally-developed models to test the results of the models used by the Company but that SFG's models used the data and assumptions from the Company's models as inputs into SFG's own models. Carnahan explained that SFG looked at the prospectus for a securitization and tried to model the transaction the way the prospectus described it. Carnahan said that SFG would then compare the results of its model with the results of the Company's model. Carnahan told us that SFG did what it felt was appropriate but did not compare "every cell in every formula" of the models. Carnahan insisted that SFG used the Company's assumptions and was not asked to review those assumptions, although he admitted that SFG commented on the models, methodologies and assumptions when it felt it was appropriate or relevant. Nevertheless, Carnahan stated that SFG's review was not a "stamp of approval" of New Century's residual interest valuations because it only looked at certain aspect of deals and not all the assumptions in New Century's models.

e. KPMG's Residual Interest Valuation Conclusion Memos

Beckstrom stated that each quarter during 2005 and 2006 he prepared a Residual Interest Valuation Conclusion Memorandum that described the specific procedures used by the engagement team to test New Century's residual interest valuations and the results of those procedures. Among other issues, incorrect estimates would be considered and discussed in

determining the reasonableness of the Company's estimates and whether Management's current estimate required adjustment.

Beckstrom and Kim stated that SFG input was necessary for Beckstrom to complete the Residual Interest Valuation Conclusion Memoranda he prepared each quarter. Each quarter, SFG would prepare an audit assistance memorandum for the engagement team documenting its review of the models selected for testing and its observations related to those models and the assumptions it used. The results of SFG's review of New Century's residual interest models and its comments about those models would ultimately be incorporated into the Residual Interest Valuation Conclusion Memoranda prepared by Beckstrom. The engagement team would review the SFG memorandum and ultimately determine whether, based on the conclusions stated in the memorandum, it would be reasonable to conclude that New Century's residual interests were not materially misstated. Kim stated that he would review the conclusion memoranda that Beckstrom prepared, which would state that SFG had tested a certain number of residual interest models and that the engagement team was comfortable with SFG's conclusions.

Beckstrom could not explain why the SFG memorandum for the third quarter of 2005 was dated November 30, 2005, a month later than the Residual Interest Valuation Conclusion Memorandum for the third quarter of 2005, which is dated October 26, 2005. Despite the discrepancy in dates, Beckstrom asserted that he used the SFG memo to prepare his Conclusion Memorandum.

There is a similar inconsistency in dates between the SFG memorandum for the first quarter of 2006, which is dated May 9, 2006, and the Residual Interest Valuation Conclusion Memorandum for that quarter, which is dated April 26, 2006. Beckstrom could not explain why the Conclusion Memorandum is dated a couple of weeks before the SFG memorandum, but claimed that, regardless of the dates on the memoranda, there was regular interaction between the engagement team and SFG regarding particular findings. Beckstrom said it is possible that he had received the information he needed from SFG to draft the Conclusion Memoranda before he received the formal SFG memoranda.

Kim claimed that, although the dates of the engagement team's conclusion memoranda might be dated prior to the dates of the SFG memoranda, there were ongoing discussions regarding the models being reviewed and residual interests generally, so that the engagement team was continually updated on SFG's progress. Kim explained that, by the time the

engagement team had finalized their conclusion memoranda, they would have had enough discussions with SFG to reach its conclusions regarding the audit or the review. According to Kim, he would receive draft memoranda from SFG that would substantially represent the final product. In his view, SFG's final memoranda was a formality.

Donovan stated that the commentary provided in SFG memoranda was "cleared" through discussions with the SFG partner, though he did not recall how this "clearing" process was documented, and the Examiner did not find any documented evidence that this "clearing" process occurred. Carnahan said that he had regular discussions with the audit partners regarding issues identified by the SFG. Carnahan characterized these discussions as "negotiations" wherein they would "try to convince each other and reach resolution." According to Kim, there were many suggestions and recommendations in the audit assistance memoranda that SFG prepared. In his interview, Carnahan claimed that SFG made "suggestions" and not "recommendations" to the engagement team. In general, Kim said, the suggestions were to make sure that the assumptions used in New Century's models were adjusted in a manner that was consistent with then-current market conditions.

In fact, the SFG memoranda indicate that SFG consistently recommended that the engagement team should:

- Compare the data in the models to the source documents provided by the Company
- Test the assumptions against supporting documentation, such as historical data
- Review the Company's results when testing its models against actual cash flows (back-testing), and
- Review the Company's support for its discount rate assumptions.

Kim claimed that all suggestions set forth in SFG's memoranda were presented to New Century and that these suggestions were "well-taken" by New Century. Kim claimed that, more often than not, New Century would implement the changes that SFG recommended, although this claim does not seem to withstand scrutiny with regard to SFG's recommendations concerning New Century's discount rates.[411]

[411] *See* Section VI.B.7.b. for a more detailed discussion of the discount rate issue.

f. Marc Macaulay's Review of Residual Interest Valuation Issues as the KPMG Concurring Partner

Macaulay stated that he did not review the quarterly SFG memoranda regarding New Century's residual interest models. Macaulay understood that SFG was doing the reviews of those models and summaries of the results were included in the engagement team's completion memoranda for each audit, which he did review. Macaulay also does not recall reviewing the quarterly residual interest conclusion memoranda.

5. New Century's Changes to Its Residual Interest Valuation Models in Late 2006 and Early 2007

During the second half of 2006, KPMG appeared to become more insistent that New Century consider changes to its residual interest valuation models, particularly with regard to the discount rates they used. The audit assistance memoranda from SFG repeatedly suggested that those discount rates might be too low and, as a result, New Century might be overstating the values of its residual interests.

New Century's discount rates, however, were not the only issues being raised about New Century's residual interest models as 2006 drew to a close. Hatch became more aggressive in questioning the Company's apparent reluctance to collapse pre-2003 securitizations and questioned the Company's continued assumption that the loans left in the securitization trusts could be sold at par when those trusts were collapsed.[412] Furthermore, the Project Kettlebell transaction that New Century considered in the late fall of 2006 raised questions about the Company's previous residual interest valuations.[413]

As a result of a detailed reexamination and analysis of New Century's residual interest valuation methodology in late 2006 and early 2007, it appears that New Century was prepared to make a downward fair market value adjustment of nearly $90 million (39%) to the residual interest valuations that it had reported as of September 30, 2006. When the engagement team that was conducting the incomplete 2006 audit asked why such a large write-down was being made, Hatch explained that additional analysis of residual interest valuations had been performed in association with Project Kettlebell.

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[412] *See* Sections VI.B.7.c. and VI.B.7.d. below.

[413] *See* Section VI.B.7.c.iii. below.

a. The Increased Emphasis on Collateral Values Rather Than Cash Flows

During the fall of 2006, Carnahan reemphasized his view that New Century should consider changing its residual interest valuation methodology by obtaining market bids for those residual interests. At a minimum, Carnahan argued, those bids would help determine the reasonableness of the valuations New Century had been obtaining from models that computed discounted present values of future expected cash flows. New Century, however, resisted this suggestion as impractical and futile, on the ground that New Century could not obtain realistic bids for its residual interests.

That point of view began to change during the fourth quarter of 2006, as the Company began to learn, in the course of the Project Kettlebell negotiations, how others might value its residual interests. As a result of those discussions, the Company's methodology for valuing residual interests began to shift from a focus on cash flows to a focus on collateral value. According to Licata, that change in focus required the Company to consider a number of market factors, including trends in home values, how similar loans were trading in the market, the coupon rate on the loans in which New Century had an interest compared to the coupon rate on other loans trading in the market, and the relative state of delinquency of the loans in the relevant trust portfolio.

As part of its new valuation methodology, New Century began to assign market values to the remaining loans in the securitization trusts by allocating them to "buckets" based on current delinquencies, each of which would be assigned a distinct market price. Licata and Hatch tried to determine these market prices by actively asking people in the market about the appropriate contours and pricing for different types of buckets in terms of discounts from par. This process continued into the early months of 2007, motivated in part by the growing realization that KPMG was beginning to change the standards it applied to the shortcomings in New Century's models.

b. KPMG's Increased Concerns About Inadequate Documentation and Inadequate Controls

In connection with its incomplete 2006 audit, KPMG expressed increasing concern about the lack of documentation supporting key assumptions in New Century's residual interest models and the inadequacy of control procedures relevant to the Company's residual interest valuations.

During their incomplete 2006 SOX review of New Century's residual interests, KPMG identified significant deficiencies regarding residual interest valuations. As a result of their 2006

"walkthrough," KPMG learned that Management did not have documentation indicating the need to adjust assumptions to the 1999 – 2002 models or how that need would be evaluated. In addition, KPMG criticized the inadequacy of New Century documentation supporting New Century's continued use of discount rates that had been in place the prior year. Similarly, KPMG criticized New Century because it did not have controls in place to revise the fair value, had no controls designed to adjust model assumptions to current market data, failed to update assumptions for 1999-2002 vintage residual models, and did not have controls for ensuring that "inputs into the models are accurate." The internal control deficiencies memorandum also expressed concerns about New Century's changes in call dates during 2006.

It is not clear why these deficiencies in documentation and controls, which applied to matters that had been in existence at New Century for a number of years, had become worthy of mention by KPMG in connection with the incomplete 2006 audit. Kim could not say whether the same deficiencies in terms of documentation and controls existed at the end of 2005 or whether different internal control tests were performed in 2005 than in 2006, such that the same deficiency noted in 2006 could not have been detected in 2005. Instead, Kim noted that the internal control deficiency workpapers for the incomplete 2006 audit were a work in progress and the language could have changed up until the year-end audit was complete.

c. The Company's Major Adjustment in Residual Interest Values in Early 2007

In February 2007, in connection with the preparation of its December 31, 2006 financial statements, New Century revised certain assumptions (discount rates, loss severity, prepayment speeds, terminal collateral values) used to value its residual interests to take into consideration then-current market conditions and the likelihood that the terminal values of the mortgage loans would be less than par value at the clean-up call date. At the same time, the Company also planned to increase the discount rate used in its residual interest valuation models. Hatch summarized these changes in a February 27, 2007 memorandum to Cloyd, Weiss, Licata, Kenneally and Sanchez ("the 2007 Hatch Memorandum").

Although New Century never issued its December 31, 2006 financial statements, documentation developed in connection with these assumption changes and the preparation of New Century's 2006 financial statements show that, because of the proposed assumption changes described in the 2007 Hatch Memorandum, the Company had revised the value of its residual interests to $136.6 million, representing a 39% write-down of nearly $90 million (from

$223.7 million to $136.6 million) of the Company's residual interests, as compared to the amount reported at September 30, 2006. The specific impacts of each of the proposed assumptions changes will be discussed in more detail below.

6. The Special Investigation Committee's Investigation of Residual Interest Valuations

According to Heller, counsel for the Special Investigation Committee of New Century's Audit Committee (the "SIC"), KPMG alerted the SIC to an issue with respect to potentially inflated valuations of residual interests in February 2007 by suggesting that the Company had, at some point in 2005, stopped making adjustments to certain assumptions (specifically, prepayment speeds and loss assumptions) in the models used by the Company to value its residual interests in pre-2003 off-balance sheet securitizations, resulting in possible overvaluations of the Company's residual interests in those securitizations.

According to Macaulay, when New Century revealed a material weakness associated with its repurchase reserves, he asked the engagement team to start thinking about whether there were any other areas that could rise to the level of a material weakness. Macaulay also asked for a "desk review" of New Century's accounting for residual interests by a partner in KPMG's Department of Professional Practice ("DPP"). Macaulay does not recall if any conclusions were reached regarding whether material weaknesses existed with respect to the residual interest valuations. But because certain assumptions in the residual interest valuation models appeared not to have been changed and because the people who controlled the residual interest models were the same people who controlled the repurchase reserve that had been materially misstated, KPMG recommended to the Audit Committee that its investigation be expanded to include residual interests.

In response to this recommendation, in March 2007 the SIC directed that its investigation be expanded to include an analysis of certain assumptions used by the Company to value its residual interests in the pre-2003 securitized loans and directed Heller, with the assistance of PwC, to conduct an internal investigation of those issues and of New Century's methodology and assumptions for valuing and accounting for the residual interests it held in off-balance sheet securitizations that occurred prior to 2003 and the financial reporting of those values. Heller and PwC subsequently determined that certain New Century financial statements might be incorrect because some of New Century's residual interests were overvalued.

On April 27, 2007, Heller and PwC met with the SIC and provided an oral report detailing the results of their investigation as of that date. On May 23, 2007, the Audit Committee brought to the attention of the Board the findings of the SIC relating to the Company's repurchase reserves and its valuation of residual interests in pre-2003 securitizations, with a recommendation that the Board authorize the filing of a Form 8-K stating that, in the opinion of the Audit Committee, it was more likely than not that the Company's 2005 financial statements were materially misstated and, therefore, that those 2005 financials should not be relied upon. This determination by the Audit Committee resulted in the filing of such a Form 8-K on May 24, 2007, in which New Century disclosed that:

> Based on recent communications with members of the Investigative Team [Heller Ehrman and PwC], the Audit Committee has determined that there were errors in the Company's previously filed annual financial statements for its fiscal year ended December 31, 2005 (the "2005 Financial Statements") with respect to both the accounting and reporting of loan repurchase losses and the Company's valuation of certain residual interests in securitizations. The Company's ability to further investigate these matters is constrained as the Company is currently in liquidation proceedings under chapter 11 of the Bankruptcy Code. However, based upon the work performed by the Investigative Team, the Audit Committee and management believe that it is more likely than not that these errors in the aggregate result in a material overstatement of pretax earnings in the 2005 Financial Statements. Accordingly, on May 23, 2007, the Company's Board of Directors concluded, based upon the recommendation of the Audit Committee, that the 2005 Financial Statements should no longer be relied upon.

The SIC's investigation suggested there might be long-term problems with residual interest valuation that were known by at least certain New Century personnel, some of whom refused to speak to the SIC's investigators and some of whom gave information that conflicted with the information provided by other individuals. Thus, in addition to recommending that the Company file the Form 8-K that the Company did file in May 2007, the SIC and its counsel recommended that the residual interest issue be investigated in more detail by persons with subpoena authority and more resources.

7. The Examiner's Investigation of Residual Interest Valuation Issues

Although the Examiner's review and analysis covered a wide range of issues related to New Century's residual interest valuations, the investigation focused most of its attention on the following six issues:

A. New Century's continued reliance on internally-developed Excel-based models to value its residual interests, even as third-party alternatives became available and flaws in the Company's models continued to come to light.

B. The Company's insistence on using relatively low discount rates for determining the net present value of its residual interest cash flows and its resistance to repeated suggestions by KPMG's SFG that it increase those discount rates.

C. New Century's failure to consider the continued viability of its assumption that all remaining loans in each securitization trust could be sold at par if and when that trust was terminated.

D. The Company's change in the clean-up call percentages for some of its older securitizations, which had the effect of increasing the value of the Company's residual interests in those securitizations.

E. The use of improper prepayment and loss assumptions in the Company's residual interest models and the failure to update those assumptions as necessary during 2006.

F. The absence of critical internal control measures for the Company's residual interest valuation models.

The remainder of this section of the report will discuss each of these issues in turn, except for the internal control issue, which is discussed in detail in Section VIII.E.3. of the Final Report.

a. Deficiencies in New Century's Residual Interest Valuation Models and the Company's Decision Not to Use Third-Party Models Instead

The investigation revealed strikingly different perceptions within New Century about the technical capabilities and accuracy of New Century's residual interest valuation models. For the reasons set forth below, the Examiner's view is that those models should have been replaced by better third-party tools by no later than 2006, if not before. Whether because of inattention, cost concerns, inertia or other reasons, the Company continued to use models that those most knowledgeable about them regarded as "antiquated" or "flawed."[414] The Examiner concludes that KPMG should not have acquiesced in the continued use of those models, particularly after a "flaw" in one such model resulted in a $9 million overvaluation of one specific residual interest at December 31, 2005.

[414] *See* Sections VI.B.7.a.ii. and VI.B.7.a.vi. of this Section below.

i. General perceptions of New Century's residual interest models by Senior Management personnel and New Century's Finance and Accounting Department

In general, many members of New Century's Senior Management seemed to know relatively little about the details of the Company's residual interest valuation models, but assumed they were producing accurate results, in part because they were being reviewed by KPMG. Even the people in the Accounting Department had no concerns about the models New Century was using to value residual interests. Although Patti Dodge recalled one time when KPMG found an error in a particular residual interest valuation model,[415] she was not aware of any additional structural problems with the models, and was surprised by the suggestion that the models were not sophisticated enough to capture all of the data from the trustee statements. Dodge acknowledged that she could not rule out the possibility that there were other errors in the models, because the models were Excel spreadsheets and there could have been problems copying cells, but she was not aware of any such problems.

ii. Concerns that Mullins and Hatch had about the Company's models

The people in the Secondary Marketing Department who operated the residual interest valuation models had a broader and deeper range of concerns about their technical deficiencies.

For instance, although Licata's residual interest valuation models were an improvement over previous models used by New Century, they were not very precise because they did not accommodate all of the information set forth on the securitization trustee statements. This created situations in which the models would not "tie out" to the trustee statements because the Licata models contained lump sum amounts for the bond tranches whereas the Deutsche Bank trustee statements broke out the amount of each tranche. The Secondary Marketing Department analysts also had difficulty reconciling information in the models to the trustee statements because some of the tranches had different "waterfall" payments and over-collateralization requirements. Furthermore, the Licata models did not manage over-collateralization account numbers well. Because the OC numbers often did not "tie out," the models often generated false "trigger" pops.[416] In addition, the databases used to perform trustee reporting and servicing

[415] Dodge was probably referring to the problem with the 2005-B model, which is discussed in part v of this Section below.

[416] A "trigger pop" was a violation of a specific covenant in the securitization agreement relating to delinquencies or other occurrences.

reporting could not hold certain details, such as income from liquidating loans or the separation of prepayments from repurchases. Since the information was not captured, it was omitted from the models.

It appears that everyone in the Secondary Marketing Department, except Licata, recognized that the models he had built for the pre-2003 securitizations were inadequate, flawed, even "antiquated," in the words of Cloyd. Although Hatch brought greater modeling expertise to the Secondary Marketing Department, even the models he created in and after 2004 contended with the limitations of an Excel spreadsheet format and were not immune from errors.[417]

Licata may not have been aware of the limitations in the residual interest valuation models because he did not have much modeling experience. Although the senior analysts who worked on the models claim that they brought these limitations to Licata's attention and discussed with him their concerns about the models' accuracy, Licata claims not to recall anyone ever suggesting that the models were inadequate or unsophisticated. He did acknowledge learning, in the period between 2005 and 2007, that the models were not capturing all relevant data and that the models' calculations were not operating properly in all instances. Licata, however, seemed quick to dismiss problems with the models as "immaterial," and he rejected as "unnecessary" suggestions that older securitizations be re-modeled to correct their deficiencies. Although Hatch grew increasingly uncomfortable with the accuracy of the models for the pre-2003 securitizations during 2006, the Secondary Marketing Department was always pressed for time, and Hatch was too busy to press the issue with Licata after bringing it to his attention.

iii. Problems with New Century's residual interest models that came to light during the Examiner's investigation

During the Examiner's review of New Century's residual interest models, we identified several problems with the models New Century had been using to value its residual interests in pre-2003 off-balance sheet securitizations:

- The mathematical routines and formulas in the models were inconsistent. For example, the calculation taking into consideration the par value assumption appeared to differ from model to model. The formulas in certain models (*e.g.*, the model for securitization 00NCB) appeared to be inaccurate since a reduction in the terminal par value percentage in those models had the effect of increasing the value of the residual interest.

[417] *See* Section VI.B.7.a.v. below.

- The routine in some models that purported to compare projected results to actual results was ineffective, in that the formulas compared actual results to actual results.
- Some models contained certain cells where data had been hard-coded into the cells instead of being formula-driven. For instance, the required over-collateralization balance in the model for securitization 99NCB was hard-coded and when that hard-coding was removed, the value of the residual interests decreased by $1.2 million at December 31, 2005. The modeled cash flow/over-collateralization step-down trigger test for model 00NCA was hard-coded and when that hard-coding was removed, the value of the residual interests decreased by $3.8 million at December 31, 2005.[418]

The Examiner could not conduct a detailed analysis of the models New Century used to value its 2005 residual interests because those models were provided to the Examiner on a hard drive containing date-organized folders and files from the Secondary Marketing Department's shared drive at New Century. When the macros contained in these models were initiated, they appeared to search for data in other files that were not provided on this hard drive. Accordingly, the macros were unable to recalculate the results when certain assumptions and other inputs were changed. This situation precluded the Examiner from conducting a complete evaluation of these models. Subject to this constraint and our limited analysis of the 2005 residual interest models, the Examiner identified the following problems with those models:

- These models were heavily reliant on macros and Visual Basic ("VBA") logic. This created a "key person" risk as it is likely that only Hatch truly understood the complexities involved in these models. The macros make it difficult to review the calculations behind the cash flow forecasts and, therefore, to locate or fix any errors in the models. Furthermore, the complexity of these models precluded an independent review of the models by New Century, as the employee designated to conduct the independent review of these models (Pyatigorsky) did not have enough experience with such complex macros or with VBA.
- An error was identified relating to how the 2005 residual interest models use the terminal collateral value assumption. Evidently, the terminal value assumption contained in these models for periods prior to December 31, 2006 was not used to compute the residual interest values.[419] This modeling flaw was corrected in the

[418] Licata claimed that cells in certain models were "hard-coded" when the models would "break" or were unable to "deal with the calculations." According to Licata, "hard-coding" would allow a model to "true up for a given calculation that the model had difficulties with." Because this process was apparently not documented, there is no reasonable way to verify Licata's explanation for the "hard-coding." But even Licata's explanation for "hard-coding" confirms the existence of deficiencies in the mathematical routines of the models.

[419] In periods prior to December 31, 2006, New Century assumed a terminal value for the collateral in the 2005 NIMS of 100%. Therefore, this error did not impact the value of the residual interests reported in those periods.

2005 models that were used to value the residual interests at December 31, 2006. Apparently, this flaw was identified in connection with the Company's decision to change the terminal values for all the securitization deals at December 31, 2006.[420]

The Examiner also reviewed an analysis done by PwC in early 2007 of models for two 2005 securitizations. Among other things, PwC determined that the models for these 2005 securitizations were deficient in that:

- The loss calculations were inconsistent with industry practice.
- The delinquency triggers were not modeled appropriately.
- The discount rates used for valuation were not product-specific, while New Century's pricing model had product-specific discount rate adjustments.
- The models were limited to 20 rep lines – limiting the models' granularity
- The processes for regular review and updates to model assumption were not defined.
- There was no model documentation.
- A significant key person risk existed, which was exacerbated by the limited documentation and use of a propriety model.
- No controls existed for model changes.

PwC also advised New Century that most of its peers were using third-party structuring tools, such as Intex, IMAKE or Wall Street Analytics, rather than internally-developed models to value their residual interests.

iv. KPMG's views regarding New Century's residual interest models

The investigation revealed conflicting information about KPMG's views regarding the sufficiency of New Century's residual interest valuation models.

According to Hatch, KPMG shared his views about the inadequacies and poor quality of the valuation models being used by New Century, particularly for pre-2003 securitizations, and agreed that New Century would need to change those models.

KPMG's workpapers reveal that KPMG's engagement team was repeatedly made aware of flaws in the Company's models. As part of KPMG's testing for data integrity for the year-end 2005 audit, KPMG discovered variances between the data inputs in the models and the

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However, this error demonstrates that there are risks associated with the use of internally-developed models, particularly when they are not subject to third-party review.

[420] *See* Section VI.B.7.c. below.

comparable data from the corresponding trustee statements, which, they were told, were due to minor flaws in the models. Beckstrom did not recall what, if anything, KPMG did to verify that the variances were a result of minor flaws in the models nor did he recall whether anyone tried to determine whether there was a need to make an adjustment to the models as a result. The workpapers for the 2004 year-end audit also discussed discrepancies that had been identified in the models.

KPMG's workpapers for the second quarter of 2006 indicate that the same or similar flaws in the models were responsible for variances between the data inputs in the models and the corresponding trustee statements. Beckstrom could not recall whether these were the same flaws that were discovered in 2005 or whether there were variances in all the models KPMG tested.

Despite knowledge of these flaws, Kim said that the engagement team had no reason to believe that New Century's models were "unreasonable." According to Kim, although there were minor flaws in the models tested and it could be assumed that there were minor flaws in untested models, that even when you extrapolated them the flaws amounted to insignificant amounts and only led to immaterial differences. How Kim could be confident of this conclusion is not clear, given that KPMG only tested two or three models each quarter.

According to Kim, if the variances had been material, the engagement team would have addressed them, but they were not concerned. Kim explained that as long as the variances, in aggregate within the specific model, were reasonable the engagement team was comfortable with the minor flaws. His concern was "reasonableness," not dollar accuracy. Kim acknowledged that there were off-setting differences within the models, and only the net difference was assessed when determining the reasonableness of the valuation. Kim discussed the minor flaws in the models with people in the Secondary Marketing Department, but because he considered the flaws to be immaterial, they were not raised as a significant issue.

Apparently, KPMG's confidence in New Century's models was not shaken even when SFG discovered an error in the quarterly valuation by one model for a 2005 securitization that resulted in a $9 million overvaluation of one specific residual interest.

v. The $9 million error produced by one 2005 residual interest model

As KPMG learned in early 2006, even the models created by Hatch for the 2005 securitizations were subject to error. The most significant such error occurred in the fourth quarter of 2005, when the failure of a model to properly account for private mortgage insurance

("PMI") payments resulted in a $9 million error in the residual interest valuation for securitization 2005-B. KPMG, not New Century, discovered this error.

There were four off-balance sheet securitizations that occurred in 2005.[421] The general residual interest model layout New Century used could not handle PMI information, so Hatch created an input for that information in a side table for securitization 2005-B. It was the only New Century deal he modeled that had a PMI strip.[422] Hatch claimed that a subordinate neglected to update the side table that included the PMI information, which led to a significant overstatement in the value of New Century's residual interest in the 2005-B securitization in the fourth quarter of 2005 when the PMI was excluded and a write-down in the first quarter of 2006 when KPMG caught the error and the information was subsequently updated in the side table.

Although the error in this model clearly occurred within the Secondary Marketing Department, it is not clear why the Finance and Accounting Department did not catch the error given the multi-million dollar difference between the amount of cash New Century would have received for this residual interest from the securitization trustee and the amount of cash it would have recorded on the basis of the model's improper calculation. Hatch claimed that the Accounting Department should have noticed a 20% write-up in a quarter of a residual interest valuation that is usually decreasing. Hatch, as the person within the Secondary Marketing Department who was responsible for portfolio reporting, should also have noticed that write-up, particularly since it related to a model he had built.

The error was discovered by KPMG's SFG during the first quarter of 2006. Donovan had asked that SFG review three residual interest models for 2005 securitizations and that SFG had identified the error in the model for the 2005-B securitization. Information about the error was relayed from SFG to Beckstrom through Kim. Despite this $9 million error resulting from only one model, Beckstrom does not recall whether anyone expressed concern regarding the accuracy of New Century's other models. Donovan told us the $9 million error did not raise any concerns on his part about the Company's remaining models. It does not appear that KPMG sought to review any additional models after discovering the error in the model for the 2005-B

[421] PwC did not review the models for those transactions as part of its work for the SIC.

[422] Hatch said that he does not know whether the pre-2003 deals had PMI strips because he did not roll or build those models.

securitization. Beckstrom acknowledged that finding an error would normally increase an auditor's skepticism regarding the accuracy of the models.

The $9 million error in the valuation of New Century's residual interest in the 2005-B securitization triggered an analysis of the materiality of that error and a discussion of whether it was material enough to require a restatement of New Century's 2005 financial statements. There was a conference call to discuss the materiality of the error in the 2005-B residual interest model. As a result of that conference call, Kenneally, on behalf of New Century's Management, prepared a memorandum (to Sanchez) dated May 8, 2006 with a description of the write-down in the first quarter of 2006 that was required to correct the error in the fourth quarter's valuation of New Century's residual interest in the 2005-B securitization.[423] Kenneally's memorandum described the failure to load a component (PMI) into the model, provided a rationale for why the error was not "material," and concluded that, because the error was "immaterial," New Century did not need to restate its 2005 financial statements - a conclusion with which Donovan agreed.[424]

Kim said that people within the Secondary Marketing Department made the adjustment to New Century's residual interest valuations for the first quarter of 2006 that KPMG recommended in light of their discovery of the $9 million error. Kim indicated that the issue of internal controls was raised with New Century in connection with that error and that New Century Management indicated that they would take KPMG's comments into consideration and implement control processes to mitigate this deficiency. According to Kim, Management took "proactive" measures to implement new controls in 2006 to prevent future errors, although he could not recall what those controls were without reviewing the year-end SOX documentation. No such changes in controls were discovered by the Examiner.

vi. New Century's consideration and rejection of third-party models

According to Hatch, New Century could have used professional third-party valuation models that would have: (a) allowed more valuation work with fewer people; (b) limited analysis

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[423] *See* the memorandum from Kenneally to Sanchez dated May 8, 2006 Re: Evaluation of Residual Model 2005-B Correction.

[424] Although, this $9 million error may have been immaterial when considered in isolation, it is only one of several errors in New Century's 2005 financial statements that this investigation uncovered, which, in the aggregate, did result in a material misstatement of those financial statements. *See* Section VII.

to model specific elements without concern about the underlying calculations; (c) allowed flexibility in the types of assumptions (*i.e.*, would have allowed the use of CPR and loss severity functions not available in the Excel models New Century used); (d) run multiple models simultaneously; (e) maintained loan-level detail rather than aggregates in rep lines; and (f) permitted scalability.

According to Mullins and Hatch, New Century had talked to vendors like Intex, Wall Street Analytics and IMAKE about using commercial software to value its residual interests, but New Century did not want to spend the money necessary to use third-party models. Hatch also said that Licata thought the weakness was in the modeler and not in the models so that professional models were an unnecessary expense.

Others did not support the view that New Century did not purchase third-party software because of its cost. Flanagan said New Century had considered purchasing Intex, a third-party vendor software, to help value New Century's residual interests and that this purchase was in the budget for 2006.[425] Flanagan said that New Century was considering Intex because Wall Street had begun to use it (it was industry standard by the end of 2005), so its use would make it easier for New Century to share information with broker-dealers (rather than converting information from Excel to Intex). Flanagan personally tested the Intex software in 2001 or 2002, but it was not well developed then, and was not in common use. Cloyd confirmed that there had been discussions about the willingness and desire to upgrade the Company's "antiquated" tools for valuing residual interests by purchasing tools like Intex and Levels. According to Cloyd, investments in this software were actually included as part of the 2006 and 2007 budgets.

The evidence is mixed as to whether KPMG felt strongly that New Century should use third-party models to value its residual interests. KPMG understood that New Century was using in-house models developed by people at New Century to value its residual interests. Neither Donovan nor Kim knew who developed the models, which used Excel software, but understood that Licata, Hatch, and Mullins reviewed and worked with the models. To Kim's knowledge KPMG did not have any involvement in the creation of New Century's models.

According to Hatch, KPMG thought New Century should use professional models, at least by 2006. But Kim disagreed with Hatch's recollection. According to Kim, KPMG generally thought that New Century had sufficient in-house people with appropriate knowledge

[425] Flanagan did not know if Intex was ever purchased because he left New Century before 2006.

to develop the models it used to value its residual interests. Donovan and Kim also told us that they believed their other clients in the subprime mortgage industry used their own, internally-designed models to value residual interests. Beckstrom did not know whether other companies used third-party models to value residual interests.

Kim claimed that, although there are products you can buy that are designed by third parties, these products require a great deal of customization and thus would likely require the use of a consultant. In this respect, Kim would not consider them to be third-party software or products, but rather, the work of an outside consultant. Kim said that an alternative to internally-developed valuation models such as those used by New Century was to hire a consultant to go through the same modeling process and develop a value. Kim did not know whether New Century ever contacted a consultant regarding residual interest valuation models. He also does not recall recommending that they do so.

vii. The Examiner's conclusions regarding New Century's residual interest models

By 2006, if not before, New Century should not have been using its internally-developed Excel-based models to value its residual interests. The Secondary Marketing Department was aware that these internally-developed models had a range of flaws and that there were third-party alternatives that would have been an improvement over the Excel-based models upon which New Century was relying. Licata's resistance to a change in modeling technology was understandable, given his personal faith in the residual interest models he had developed, but other people at New Century – above and below Licata – who had less of a personal investment in those models should have pushed harder to replace them with better tools.

The Examiner's understanding is that mortgage companies with similarly sized assets often used independent third-party models rather than internally-developed in-house models because of the risks associated with the use of internally-developed models, particularly when they are not subject to third-party review. This understanding is supported by PwC's advice to New Century, in February 2007, that most industry peers with similarly sized assets used a third-party structuring tool to value their residual interests.

The Examiner understands that, even when internally-developed models are used, there is typically some form of documented testing of the models by an independent third-party to ensure the models are performing their calculations correctly. When a mortgage company uses its own models (for example, Microsoft Excel-based models) to value its residual interests, it is "best

practice" and not uncommon for a third-party to be retained to value the mortgage company's residual interests at year-end using the third-party's own models.[426] The mortgage company can then calibrate its models to achieve results consistent with the results attained by the third-party so the internally-developed models could continue to be used on an interim basis with some level of confidence. New Century did not follow these "best" practices.[427] In the Examiner's view, the limited testing by the SFG at KPMG of only two or three models per quarter was not an adequate substitute for the kind of testing that should have taken place, particularly given the "flaws" and errors that KPMG found in the course of its testing.

The Examiner cannot quantify the potential impact on New Century's financial statements of its continued use of flawed, internally-developed models for valuing its residual interests. As we have described above, KPMG found at least one instance in which one of the models it tested had overstated a single residual interest by $9 million in one particular quarter. It would be difficult and time consuming to determine if there were similar million-dollar errors in the dozens of other residual interest models that were not tested each quarter. But one lesson to be drawn from New Century's experience is that a publicly-listed financial services company, like New Century, should be using better technology to value the financial assets it reports to investors and the public, particularly when those values rely on complex assumptions and judgments. Repeatedly dismissing "flaws" in antiquated valuation models is a recipe for disaster.

b. New Century's Prolonged Insistence on Using Low Discount Rates to Value Its Residual Interests

As previously discussed, the results produced by New Century's residual interest valuation models depended heavily upon the assumptions they used. A key assumption for these purposes was the discount rate used in each model to compute the present value of the net cash flows associated with the residual interest in the securitization to which that model related. The valuation of New Century's residual interests bore a direct but inverse relation to the discount

[426] Although Flanagan and Dodge suggested that a third-party had been asked to review New Century's models, their recollections on this subject were vague and unsupported by any documentation. Furthermore, if there was a third-party review of New Century's residual interest valuation models at some point in the past, that review did not cure those models of deficiencies that were readily detected by Mullins, Hatch and KPMG in 2005 and 2006.

[427] In addition, a third-party would likely create or insist that New Century create documentation that described the various mathematical routines and formulas in the models. As discussed in Section VIII.E.3. of the Final Report, New Century never created such documentation.

rates used in the residual interest models. If the discount rates increased, the residual interest valuations would necessarily decline.

New Century's choice of discount rates – 12% for residual interests in CE securitizations and 14% for NIMS residuals – was a subject of continuous discussion by New Century and certain people within KPMG during 2005 and 2006. By late 2006 or early 2007, New Century's Board of Directors and Senior Management had come to the conclusion that these discount rates were too low and would result in an overvaluation of the Company's residual interests. The Examiner has concluded that those discount rates should have been increased much earlier than the end of 2006, and that, by failing to do so, New Century overstated the valuations of its residual interests by no less than $14.8 million at the end of 2005 and by comparable amounts in 2006.

i. New Century's discount rates for residual interest valuations prior to the end of 2006

Over a six-year period of considerable turbulence in general interest rates and significant changes in the subprime mortgage market, the discount rates that New Century used to value its residual interests remained remarkably stable. As the following table demonstrates, throughout most of that time period, including every quarter from the second quarter of 2002 until the third quarter of 2006, the discount rate that New Century used for its residual interests in standard CE securitizations was 12% and the discount rate that it used for NIMS residuals was 14%.[428]

	Q2 2000 – Q3 2000	Q4 2000 – Q3 2001	Q4 2001 – Q1 2002	Q2 2002 – Q3 2006
CE Securities	12%	13%	13%	12%
Pre-2001 NIMS	14%	15%	15%	14%
2001 NIMS	-	-	20%	14%
2005 NIMS	-	-	-	14%

With one exception, during the six quarters from the fourth quarter of 2000 through the first quarter of 2002, when New Century increased its discount rates, it did so by only 1%.

The Company provided various reasons for returning its discount rates in the second quarter of 2002 to 12% and 14%, including: (1) current market rates, which were at a 40-year low; (2) the fact that the residual portfolio was hedged against interest-rate risk; (3) additional CPR had been added to all fixed-rate products; (4) losses were increased by approximately 26 basis points; and (5) year-to-date, the Company had repurchased over $70 million in seriously delinquent loans from the residual portfolio.

[428] We have been told that the higher 14% discount rate for NIMS residuals was intended to reflect their greater risk.

It is not clear who within New Century determined the discount rates that were used in New Century's residual interest valuation models prior to 2003 and who had the responsibility for reconsidering those discount rates in the years thereafter.[429] What is clear is that, until 2006, New Century did not go through an analysis similar to the analysis described in June 2002 to consider whether its discount rates for residual interest valuation should be adjusted, even though some of the factors that supported the Company's previous adjustment of discount rates in 2002 had substantially changed. This was so even though, in about 2005, New Century increased the discount rate on securitizations done at the REIT level to 18%, purportedly to reflect the higher risks associated with such securitizations[430] and even though KPMG's SFG frequently questioned New Century's discount rates during 2005 and 2006, observing that they were low when compared to the discount rates used by other similar companies.

Even apart from the concerns expressed by KPMG (which will be discussed below), there is evidence that Senior Management within New Century had reason to believe as early as 2005 that its residual interest discount rates might be too low. Certain officers, including Cloyd, were aware, by at least July 2005, of the downward turn in the subprime mortgage market and the concomitant increase in risk associated with its residual interest portfolio. Internal e-mails in December 2005 suggest that senior executives were aware that any secured financing relating to residual interests would carry interest rates close to 25% and that an increase in New Century's residual interest discount rates to that level would result in a substantial reduction in the valuations of those residual interests.

ii. The SFG's increasing concerns about New Century's discount rates during 2005 and early 2006 and the responses of New Century and the KPMG engagement team

At least as far back as May 2005, SFG, led by Carnahan, consistently produced memoranda that suggested New Century's discount rates might be too low and that urged

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[429] Cloyd, Licata and Hatch consistently suggested that, unlike other assumptions in the residual interest valuation models, the Finance and Accounting Department had responsibility for setting the discount rate assumptions in those models. But Walker suggested that the Finance and Accounting Department looked to the Secondary Marketing Department for guidance about what discount rates it should use for valuing residual interests.

[430] Licata said that the Company used an 18% discount rate for securitizations at the REIT level in order for those deals "to make sense." He also claimed that, although the assets in REIT securitizations and in off-balance sheet securitizations were similar, a higher discount rate was justified by certain REIT requirements, the tax implications of REIT deals, and higher costs of capital for REIT deals. Licata claimed that the discount rate for the REIT securitizations was dictated by the Finance Department.

KPMG's engagement team to require New Century to supply information that would support those low rates. During his interview, Carnahan insisted that he never "recommended" that New Century increase its residual interest discount rates and did not tell anyone that the discount rates were "too low," but merely observed that New Century's discount rate was at the low end of the acceptable range. In this respect and others set forth below, Carnahan's statements seem inconsistent with the language and tone of the memoranda he signed during 2005 and 2006.

In an audit assistance memorandum prepared for the quarterly review for the first quarter of 2005, SFG noted that New Century's 12% discount rate:

> [I]s at the low end of the range compared to similar issuers. SFG notes that other issues have been typically using residual asset discount rates principally ranging from 12% to 35% per annum. The client should provide supporting information for their discount rate assumption. Examples of supporting information are a letter from an Investment Bank or market information based on comparable assets with similar ratings (the Company should estimate the implied rating for their security), risk and duration profiles (*i.e.*, High Yield Corporate Bonds or ABS bonds rated B).

The same recommendation for the same reason appeared in the audit assistance memoranda SFG provided for the second and third quarters of 2005. SFG never saw such documentation in 2005, although Carnahan told us he believed the engagement team had seen it. But Kim could not recall whether New Century provided the supporting information that SFG suggested during the reviews for the first three quarters of 2005 or whether the engagement team pressed New Century to provide such information. Donovan did not recall seeing any documentation of New Century's discount rates until some point in late-2006.

In connection with the 2005 year-end audit, New Century did provide KPMG with a memorandum that tried to support its discount rate assumptions. While this memorandum discusses some of the issues that would need to be considered to arrive at an appropriate discount rate, its basic approach was to: (a) consider the yield curves of low-rated debt issues; (b) add a premium; and (c) then compare the results to the discount rates used by New Century to value its residual interests. New Century claimed that, by basing its analysis on yields associated with Composite USD B-rated bonds, it was comparing its discount rates to "third-party financial instruments and their relative spread to Treasuries as assets that have similar cash flow characteristics."

The Company's memorandum did not explain why the yield of low B-rated debt issues was an appropriate benchmark for its analysis nor did it provide any evidence to support the spread (or premium) between the yield of those debt issues and the discount rates used to value the Company's residual interests.[431] In fact, KPMG's SFG stated, at a later time, that "junk bonds are not comparable nor an average of all 'B' rated bonds since most are junk corporate bonds and few are asset-backed."

Despite these deficiencies, the KPMG engagement team reviewed and relied upon the Company's analysis in determining that the Company's residual interest discount rates were reasonable. According to Kim, at the time of the review, the engagement team and SFG, after analysis of the Company's position, agreed that the use of a four-year B-rated bond was an appropriate way to evaluate whether the discount rates being used were reasonable. He said they also agreed that New Century's justification for the 12% and 14% discount rates the Company was using was reasonable. Kim stated that he also accepted the Company's position that the discount rates being used by New Century's competitors were not indicative of the rates it should be using because every portfolio or loan pool is different in nature, not only because it is composed of different loans, but because the loans are underwritten by different companies and different companies have different underwriting guidelines. As a result, Kim said, a generalization cannot be made regarding a single industry-wide discount rate.

The Company's justification of its discount rates did not indicate that the Company had considered the market values or recent sales of residual interests, as recommended by SFG. For example, in its memorandum for the December 31, 2005 year-end audit, SFG observed that "we are aware of numerous residual interest sales in the last year and [sic] with the average discount rate in the range of 18% to 25% depending on the other assumptions." Similarly, in an e-mail dated February 14, 2006, Carnahan advised the engagement team that numerous clients had sold residuals in the 2005 financial year and that the average discount rate was 18% to 23%, depending on other variables. In relation to New Century's residual interests in 2005 securitizations, Carnahan observed that for similar NIMS products, Washington Mutual had used a discount rate of 35%, and Countrywide Financial had used a 40% discount rate.

[431] Morrice told us that he believed the decision to base New Century's residual interest discount rates on the lowest B-rated bonds was made by Colombi, working with Goldberg. But Goldberg told us he had no involvement in the discount rate issue until September 2006 and that he did not believe the yield on B-rated bonds was a proper basis for determining the discount rate for residual interest valuation.

Thus, SFG's own documents are inconsistent with Kim's characterization of the consensus he claimed to exist between the engagement team and SFG on discount rate issues when work was being completed on the 2005 audit.

SFG's concerns about New Century's discount rates appeared to become increasingly urgent during 2006. SFG's audit assistance memorandum for the first quarter of 2006 stated that the 14% discount rate New Century was using for its 2005 NIMS residual interests:

> [I]s the lowest discount rate we have seen used by others recently for similar assets. Based on discussions with market participants, residual asset sales in recent months were priced to yield 23% - 30% return on the asset. While these sales do not necessarily define an active market they are hard to ignore. NC should provide supporting information for its discount rate assumption as compared to other market information. Applying higher discount rates to the retained assets would reduce the value of the assets . . .

As part of the quarterly reviews for the first, and second and third quarters of 2006, SFG continued to urge the engagement team to ask New Century for more documentation to support its discount rate assumptions. Carnahan increasingly emphasized the importance of looking for possible market valuations of residual interests because, in his view, the market for those interests had grown so substantially that market bids might be a preferable alternative to continued reliance on calculations of discounted present cash flow. For example, in June 2006, Carnahan suggested that New Century look to:

> 7. Comparable securities that trade (the ones most commonly referred to as 'B' rated CMBS bonds (8% (15 years) to 12% (30 years)) over comparable durations and treasuries.
>
> 8. Benchmark other SEC reporting entities with similar assets.
>
> 9. Since so many residuals have been traded in the last year, obtain sufficient information from the investment bankers to use in reversing the discount rate (or get a bid/valuation on a NC residual).

The repeatedly expressed and increasingly strong expressions of concern by SFG seemed to have little impact on KPMG's engagement team. Neither Donovan nor Kim was troubled that the engagement team may not have insisted upon the supporting documentation that SFG had recommended during each quarterly review in 2005 and 2006. Donovan argued that quarterly reviews are just that—"reviews" as opposed to audits—and that KPMG's responsibility on quarterly reviews was to advise the Company whether any changes are necessary in order to comply with GAAP. According to Kim, SFG's comments were discussed with people at New

Century as part of the quarterly reviews, but the engagement team's primary objective was to determine the reasonableness of New Century's discount rates. Kim stated that, although SFG continued to suggest that New Century document the bases for its relatively low discount rates, the engagement team continued to conclude that the Company's discount rates were reasonable without documentation. From Kim's perspective, documentation would only have been required as part of the year-end audit.

Kim ultimately had no explanation for why SFG recommended additional information from New Century supporting its discount rate assumptions quarter over quarter, yet the engagement team concluded that New Century's residual interest valuations were reasonable without such documentation. Despite evidence to the contrary, Kim insisted that SFG had a similar opinion to that of the engagement team regarding New Century's discount rates, and that SFG's concerns were addressed with the Company each quarter during 2005 and 2006. According to Kim, New Century's Management was repeatedly told, throughout 2006, that the Company's discount rates were at the aggressive end of the range of discount rates used by companies in its industry, and that the engagement team would continue to monitor their discount rates and analyze them in light of changes in the market. They also asked the Company to do the same. Kim insisted that, even though New Century's discount rates were considered to be "aggressive" and "at the low end of the range," the engagement team, including SFG, concluded that they were reasonable. Kim stated that in his personal opinion the 12% and 14% discount rates that New Century used in 2005 and 2006 were reasonable, although this statement appears to be inconsistent with concerns Kim expressed to at least one person in New Century's Secondary Marketing Department, who recalled that Kim frequently raised questions about New Century's discount rates.

Donovan, like Kim, took the position that SFG, despite the issues raised in their audit assistance memoranda, ultimately agreed that New Century's valuations were reasonable quarter after quarter through the third quarter of 2006. According to Donovan, he deferred to SFG and, in particular, to Carnahan, on such matters. Donovan said that he had discussions with Carnahan regarding the adequacy of the discount rate used in New Century's residual interest models as early as the first quarter of 2006. He also recalled the discount rate issue being addressed in SFG's audit assistance memoranda, that they placed New Century's rate "at the low end of the

range," and that they repeatedly suggested that New Century provide documentation in support of its discount rate.

Donovan acknowledged that the discount rate concerns expressed in SFG memoranda could properly be viewed as "Scott Carnahan's opinions," as Carnahan was the most senior SFG individual noted on the memos. Donovan insisted, however, that, upon discussing the discount rate issue, Carnahan "ultimately agreed with the Company's rate in all instances through the third quarter of 2006," although Carnahan maintained that the discount rate issue would need to be revisited in the fourth quarter of 2006. Donovan said that he relied on Carnahan to make these determinations, and that he "never" disagreed with him. Donovan also claimed that Carnahan agreed with the engagement team's conclusion memoranda, which expressed no disagreement with the Company's residual interest discount rates.

iii. KPMG's representations to the Audit Committee about New Century's residual interest discount rates

KPMG, through Donovan and Kim, repeatedly told the Audit Committee that New Century's residual interest discount rates were acceptable, although at the low end of the range of discount rates being used in the industry.[432] Management gave the Audit Committee the same assurances, *i.e.*, that New Century's discount rates were within the range of acceptable comparables. Zona told us that the fact that New Century's discount rates were lower than others in its peer group raised issues in his mind, but that KPMG informed the Audit Committee that New Century's discount rates complied with GAAP. Morrice recalled that the discount rate issue was discussed frequently at Audit Committee meetings.

Dodge's recollections were slightly different. Dodge recalled that the Company's residual interest discount rates were frequently discussed at the 2006 Audit Committee meetings and that KPMG "pushed back" with regard to those rates during 2006. Dodge also said that the discount rate was discussed in her hour-long meetings with KPMG prior to each Audit Committee meeting. Dodge said that KPMG never argued that New Century's discount rates

[432] According to Forster, by informing Board members that New Century's discount rates were "acceptable," KPMG put their "stamp on it." Donald Lange recalled that the Company's discount rate was lower than its peer group, but he did not think it was "aggressive accounting." Lange said that Zona "was leading the charge" regarding residual interests and the appropriate discount rate.

were inconsistent with GAAP. Rather, Dodge stated, KPMG argued that the Company's discount rate was low when compared to the Company's peer group.[433]

iv. Increasing attention to the discount rate issue in the second half of 2006 by New Century and KPMG

Even if Kim claims he was comfortable with the discount rates New Century was using to value residual interests during 2005 and 2006, the concerns expressed by SFG received more attention during the second half of 2006.

Hatch became aware in early to mid-2006 that KPMG thought the Company's discount rates were too low because the industry standard was higher for New Century's asset type. Walker recalled a dialogue with KPMG related to documentation of the discount rates used to value residual interests, including a conference call with Carnahan in July 2006 during which Carnahan stated that the Company was not valuing residual interests appropriately. According to Walker, other participants in this dialogue included Kenneally, Donovan, Kim, and Justin Ayre from KPMG. Walker recalled that KPMG representatives repeatedly questioned why New Century was using a 12 – 14% discount rate when other companies were using a higher one. Walker's recollection is that Kenneally gave KPMG some backup to support the Company's use of the 12 – 14 % discount rates, but she believes Kenneally would have asked the Secondary Marketing Department about any issues relating to those discount rates.

Discussions regarding the possibility of increasing the discount rates the Company used to value residual interests became more serious later in the third quarter of 2006. On September 5, 2006, Carnahan, Donovan and Kim of KPMG met with Kenneally, Licata and Goldberg of New Century to discuss Carnahan's concerns. Donovan did not recall where the September 5 meeting occurred, or whether he or Carnahan specifically requested it, but he remembered that Carnahan used the meeting to communicate to New Century Management his concerns about the Company's discount rate, which Donovan believes were prompted by changing market conditions. According to Goldberg's memo summarizing the meeting, Carnahan "noted than when compared to other companies in the space he works with or follows, while [New Century's] loss assumptions are essentially in-line with the rest of the industry, [its] CPRs are

[433] Cloyd also recalled that KPMG questioned the discount rate because it was below the rate used by the Company's peer group. Cloyd did not recall ever being concerned about the discount rate or ever having discussions with anyone about the impact that a higher discount rate could have on the Company's financial statements.

slower and [it has] the lowest discount rate." Goldberg's memo stated that KPMG's comments were directed to the 2005 securitization transactions because KPMG viewed "the older residuals as both immaterial, and a lower discount rate [was] justified due to age." Carnahan and others discussed several alternative methodologies, including bids from third parties, which the Company might use to determine the value of its residual interests.

New Century representatives responded that, while what others were doing was interesting, it might or might not be an appropriate basis of comparison given the distinctive characteristics of the collateral in the securitizations in which the Company had residual interests, the Company's views of credit quality, and other factors. In addition, New Century's representatives observed that the SEC staff had recently reviewed New Century's Form 10-K, and in particular the notes related to residual interests, and had made no comments regarding the Company's discount rate, although it is not clear why the failure to provide such comments should have been a source of comfort to the Company.

Although Kim said the September 5 meeting was one of the "ongoing" discussions between KPMG and New Century regarding residual interest discount rates, Donovan did not recall such meetings taking place in previous quarters.[434] Donovan stated that there was "not much of a reaction" on the part of Management to Carnahan's observation that the Company was using the lowest discount rate in the industry because New Century's Management had their own justification for the rates they were using. Furthermore, Donovan shared the view that "no two securitizations are alike" and that the "underlying collateral is different," and thus that the use of other companies' valuations was merely one "data point" to consider.

In his interview with the Examiner, Carnahan characterized the September 5 meeting with New Century in ways that were different from Donovan's recollection and Goldberg's contemporaneous memo describing the meeting. Carnahan insisted that he did not suggest to New Century that it might need to raise its residual interest discount rates during the meeting and that the focus of the discussion had been less on valuation issues than on residual interest transactions taking place in the marketplace, internal controls and the need for better documentation of New Century's discount rates.

[434] Kim did not recall the details of the discussion at the September 5 meeting, other than that it probably concerned discount rates used in the industry.

Kim told us that KPMG got comfortable with New Century's discount rates in part, he recalled, because there were comparables in the market that supported the Company's discount rates. It is not clear what "comparables" would have supported this conclusion.

Potential concerns about New Century's residual interest discount rates were brought to the attention of the full Board of Directors shortly after the September 5 meeting with KPMG. It appears that a focus of the Board discussion on September 8, 2006 was how a change in the residual interest discount rates would affect the Company's earnings. The minutes state that Dodge "reported that a change in the discount rate for the Corporation's residual assets could cause a write-down but that Management was actively working with KPMG with respect to that matter. . . . Ms. Dodge then responded to the Board's questions regarding the impact that a change in the discount rate for the Corporation's residual asset could have on EPS."

Morrice recalled learning about Carnahan's concerns, but regarded them as less of an attack on the discount rates that New Century was using than a desire by Carnahan not to have to explain New Century's discount rates to other KPMG clients. According to Morrice, Carnahan acknowledged that New Century was able to support its discount rate, but that Carnahan's other clients used a higher discount rate than New Century and Carnahan wanted New Century to increase its discount rate to "make things easier." According to Morrice, New Century did not want to base the discount rates it used on what peer firms were using because: (1) looking only at the discount rates used by peer firms can be inaccurate because a discount rate reflects cost of capital, which varies by firm; and (2) New Century wanted a formulaic process to determine its discount rates and did not want to wait for its competitors to reach a decision about discount rates before New Century would know what discount rate it should use.

In an internal New Century e-mail chain on October 5, 2006, Kenneally also suggested that KPMG was pressuring New Century to raise its residual interest discount rate because of "pressure from other clients." Donovan could not recall any such discussions with New Century, and stated that he did not receive any "pressure" from other clients regarding New Century's discount rate. When asked whether he felt the "true sensitivity" of the discount rate issue had been adequately conveyed by KPMG to New Century during the September 5, 2006 meeting, Donovan stated, "I don't know."

Sanchez remembered that KPMG (and in particular Carnahan) was encouraging New Century to increase its discount rate to 18% because they "felt other people in the market were at

that level" and that New Century was using only 12 – 14%. Sanchez recalls Kenneally saying that the Company felt it was justified in using 12 – 14% because some residuals were sold at that value and KPMG was basing their analysis on a "fire sale" of some residuals.

In the weeks following the September 5 meeting with KPMG, Goldberg undertook a fresh analysis of New Century's discount rates. Goldberg said Dodge and Kenneally asked him to perform an analysis of New Century's residual interest discount rates by starting "with a blank piece of paper" and figuring out how he would calculate the appropriate discount rate. To conduct his analysis, Goldberg looked at the methodology that the Company had used to calculate the discount rate. Goldberg did not think that the Company's residual interests could be compared to low B-grade corporate bonds, which was the premise for the Company's previous discount rate analyses. Goldberg said that he looked at implied rates of return on other financial instruments and at the Company's cost of capital. He also looked at publicly available data about the discount rates being used by New Century's competitors, but said that he did not consider those discount rates to be dispositive or even highly important in conducting his empirical analysis. Among other comparables, Goldberg considered the yield on Ba2 Residential Mortgage-Backed Security ("RMBS") instruments, which Goldberg adjusted by a risk premium of 200-300 basis points (to account for the additional risks associated with residual interests).[435]

The results of Goldberg's analysis were set forth in a presentation dated October 2006 and entitled "Residual Discount Rate Analysis." Goldberg's analysis concluded that although New Century's rates – 12% for residual interests in CE securitizations and 14% for NIMS residuals – were at the low end of the ranges established by his alternative methodologies, they were within those ranges. Nevertheless, on the basis of his discount rate analysis, Goldberg, Dodge and Kenneally jointly concluded that it was appropriate to raise the Company's residual interest discount rate to 15%. Goldberg said this was a "joint" recommendation. Apparently before reaching that recommendation, Kenneally ran sensitivity analyses of the impact of possible changes in the discount rate on New Century's earnings per share.

Kenneally sent Goldberg's analysis to KPMG in "draft form." Donovan conceded that New Century was probably seeking KPMG's input in preparing the document, even though the purpose of the presentation was to provide KPMG with documentation in support of New

[435] This premium reflected the difference in yield between Ba1 and Ba2 rated bonds.

Century's discount rates. Donovan claimed that sending such a document in draft form to KPMG was appropriate and "not uncommon at all—numerous clients would do that." Kim, on the other hand, claimed that there would be no reason for the Company to send KPMG a "draft" of an analysis because KPMG would only provide comments on a "final version" of a document, not a "draft," given that the Company had to formulate its own conclusions and analyses. According to Kim, although the document from New Century says "draft," it was probably because the Company forgot to remove the "draft" language prior to circulating the document.

The Goldberg analysis provoked a number of reactions within KPMG. For instance, Kim observed that Goldberg's analysis did not necessarily support New Century's current discount rates because "if you strictly use the Company's analysis, we could conclude that a 13% discount rate should be used for all deals prior to 2003 and 16% should be used for all 2005 deals as these are the lower ranges." Indeed, the Examiner has noted that the high range of the discount rates in Goldberg's analysis is 16.3% to 20.0% — which is above both New Century's then-current rates and the 15% discount rate Goldberg, Dodge and Kenneally ultimately recommended.

Donovan also sent the "draft" of Goldberg's presentation to Carnahan to obtain his comments. Carnahan had several responses. Among other things, he noted that Goldberg's analysis had not considered the prices paid by buyers of residual interests or possible bids for New Century's residual interests, ostensibly because the Company felt there was not a listed market for these residual interests and a firm that systematically did not want to hold residual interests might be willing to accept a lower price than a firm that is comfortable retaining such interests. Carnahan disagreed, asserting that "[New Century] could get a bid on a deal at any time [as t]here are active buyers of this right now." As a result, he asked "why is this method being ignored."

Donovan did not disagree with any of Carnahan's comments on Goldberg's analysis, and forwarded them to New Century with a message stating: "see Carnahan's comments - the one I agree with is that we should get a bid." Even though the possibility of obtaining bids had been discussed at the September 5 meeting, and both Carnahan and Donovan agreed the Company should do so, Donovan claimed that Carnahan ultimately "agreed" with the Company's decision not to seek a bid during the third quarter of 2006. According to Donovan, one reason Carnahan backed off his insistence upon bids in the third quarter was because of the distinction, from KPMG's perspective, between a quarterly "review" and a year-end "audit" and because KPMG

was urging New Century to obtain bids in the fourth quarter. Donovan stated that Carnahan would have liked New Century to obtain bids for the third-quarter review, but agreed it was not required because it was only a review and because a bid would only be one data point to consider in determining the fair value of New Century's residual interests.

Goldberg recalled Carnahan had wanted the Company to call Wall Street firms and get bids on their residual interests. Goldberg said that he thought it might be possible to get bids on New Century's residual interests, so he talked to Licata about the possibility of contacting Wall Street firms to obtain such bids. Goldberg said that Licata told him he would not bother to do so because he did not think the bids New Century would receive would be accurate. Goldberg said that, although he had worked at Morgan Stanley, he did not have contacts with the fixed income desks that would have been the sources of bids on the Company's residual interests.

During October 2006, at or about the same time that Goldberg was undertaking his analysis of New Century's residual interest discount rates, Kenneally undertook a survey of accounting policies of New Century's peer firms, as set forth in their most recent public filings, which indicated, among other things, that the residual interest discount rates used by New Century's peer firms ranged from 18% to 22%.

The concerns expressed by KPMG regarding New Century's residual interest discount rates became a subject of discussion at ALCO meetings. According to Garday, the primary participants in those discussions were Dodge, Kenneally, and Goldberg. In general, the theme of those discussions appeared to be that New Century was at the low end of the discount rate range for KPMG's clients and that it needed to continue to justify those low discount rates if it did not want to propose or accept a higher one. From Garday's perspective as the chair of ALCO, the discount rate issue appeared to be a matter of "arm-wrestling" between New Century and KPMG. Although ALCO minutes state that Kenneally approached ALCO to ask whether New Century should maintain its existing discount rates, ALCO never made a decision about what discount rate New Century should use. Garday considered ALCO a "forum" for getting input from everyone on a significant issue, but not necessarily the group to decide such issues. Instead, it appears, the discount rate issue was taken to New Century's Finance Committee.

v. The Finance Committee's decision not to raise the residual discount rates and KPMG's response

Although New Century's Management had been reluctant to change the Company's residual interest discount rates, because it believed it had some "good comparables of sales that

could justify" the rates it was using, in light of Goldberg's analyses and Carnahan's concerns, Dodge, Kenneally and Goldberg and others in Management agreed to recommend an increase in the residual interest discount rates to 15%, even though it would have caused a "hit to earnings." This recommendation was presented to the Finance Committee of the Board on October 16, 2006.

According to the Finance Committee's minutes, "[a]fter a lengthy discussion, the Committee and Management decided not to change the residual discount rate at the time." Despite extensive questioning on this subject, we have not identified a clear and consistent explanation for this surprising decision, particularly in light of concerns expressed by some independent directors in other contexts about not wanting New Century to engage in aggressive accounting.

Sachs, who chaired the Audit Committee and was a member of the Finance Committee, recalled that both Management and KPMG had concluded that New Century's discount rate was within an acceptable range. Sachs recalled that the Finance Committee supported a less conservative discount rate in mid-October 2006 because discount rate analysis was not a science and the Committee had no basis to say that a 15% or 17% discount rate was correct. Even though Sachs acknowledged that everyone knew a lower discount rate resulted in higher residual interest valuations, he emphasized that New Century had a duty not to overstate or understate its residual interests.

Zona, who was normally aggressive in challenging what might be aggressive accounting treatment, offered a more curious explanation for the Finance Committee's decision. According to Zona, he thought the Company's residual interest discount rates should be even higher than the 15% that Management was recommending and was concerned that approving a small increase from 12% and 14% to 15% would subject the Company to outside criticism and might also make it more difficult to increase residual interest discount rates to a more appropriate level in the near future.

According to Dodge, the Finance Committee reached a consensus that there was no reason to use a higher discount rate to value the Company's residual interests because Project Kettlebell was expected to conclude around the end of 2006 and the 12-14% discount rates used by the Company were within the range of discount rates determined to be reasonable by

Goldberg's analysis. Dodge stated that other factors probably also contributed to the Finance Committee's decision not to raise the discount rate.

Although Gotschall and Donald Lange recalled discussion about increasing the discount rate a small amount at the October 16 Finance Committee, they claimed (it appears incorrectly) there was nothing to vote on because no specific recommendation to increase the residual interest discount rate was made. Gotschall recalled that the Finance Committee told Management to work with KPMG and make a proposal.

The Finance Committee's decision not to increase the residual interest discount rates was a surprise to many people at New Century, including Goldberg and Kenneally, because the Company had already booked its residual interest assets for the third quarter of 2006 using a 15% discount rate prior to the Committee's meeting and had to "un-book" the higher discount rate after the Finance Committee meeting. Goldberg said that he was surprised that the Finance Committee decided not to increase its discount rates to 15% because KPMG had questioned the Company's discount rate and management had recommended a change in that discount rate. Goldberg, who did not attend the Finance Committee's meeting, was not aware of any connection between the Committee's decision and Project Kettlebell.

Donovan recalled having a conversation with Kenneally in which he learned that either the Audit Committee or the Finance Committee had decided to stay with the 12-14% discount rates rather than increasing them to 15%. According to Donovan, Carnahan was comfortable with New Century's decision not to adjust its discount rates in the third quarter of 2006, although he continued to suggest that the Company seek bids for its residual interests during the fourth quarter. Donovan indicated that Carnahan wanted the Company to develop additional data points that could be considered by KPMG in its evaluation of Management's estimates as part of the annual 2006 audit. Donovan could not recall many specifics, other than that KPMG "signed off" on the Company's third quarter of 2006 discount rate and stated that the Company would need to revisit the issue in the fourth quarter of 2006.

The draft version of KPMG's Interim Completion Document for the third quarter of 2006, which apparently was written before the Finance Committee's decision, reflected a change in the discount rate to 15% that would have required a $7 million audit adjustment, whereas the final version of the same KPMG document contained neither of these elements. In the draft

document, the note regarding "discount rate" states: "KPMG determined that in an appropriate range of discount rates, 15% would be the low end of the range."

According to Kim, the notation in the draft version of the KPMG workpaper indicated that KPMG was proposing an adjustment of $7,028,823 to New Century's residual interest valuations, which reflected the difference resulting from a change in the discount rates previously used by New Century and the new 15% discount rate. In the final version of the same KPMG document, the passage in the draft document regarding the change in discount rates has been deleted. Kim did not recall why the change appeared in the draft document and not the final, but explained that, ultimately, KPMG reached the conclusion, when it signed off on the third quarter review, that it was comfortable with the 12-14% discount rates. Kim explained that there is a paragraph in the final version of KPMG's workpaper supporting that conclusion. Kim did not recall discussing the change in language, but indicated that based on the final document, the engagement team had had enough discussions internally to conclude that 12-14% discount rates were reasonable at that time.

An e-mail from Kenneally on October 17, 2006, on which Donovan was copied, stated: "John [Donovan] and I just spoke regarding the Discount Rate. The current rates are acceptable, although KPMG will once again point out in the Audit Committee Meeting that there is some risk to such a rate as they did previously." Donovan contended that he did not come to the conclusion that New Century's current discount rates were acceptable until later, after reaching agreement with Carnahan on this matter, and thus that any such statements by Kenneally as of October 17 would have been merely "preliminary."

vi. New Century ultimately agrees to raise its residual interest discount rates for the fourth quarter of 2006

Later in 2006 or early in 2007, New Century's Management and Board determined that the Company had to increase the discount rates being used to value its residual interests. The only issue was by how much. One impetus for this change in attitude was the information New Century learned, through its negotiations concerning Project Kettlebell, about how others valued New Century's residual interests. A second reason for this change in attitude was the arrival of Bindra, who questioned a number of the Company's long-held assumptions. A third influence was the increasing pressure from KPMG.

(a) Project Kettlebell

According to Licata, during the course of the Project Kettlebell negotiations, the Company learned that neither Carrington Capital, with which New Century was negotiating, nor New Century's financial advisor, which solicited bids for New Century's residual interests, agreed with the Company's residual interest valuations. The analyses and discussions that accompanied Project Kettlebell persuaded Licata and New Century's Management that, even if the Project Kettlebell transaction did not close, the Company would need to move toward a "mark-to-market" methodology that was becoming more common in the industry. As a result, the Secondary Marketing Department began to analyze how the assumptions in their residual interest valuation models would need to be changed.

(b) Taj Bindra

Bindra's understanding was that the Company had been using a 14% discount rate for a long time, and that this had been known to the Audit Committee, to Management and to KPMG. After Bindra joined the Company, a few Directors asked if New Century's accounting had been too aggressive in various respects. Those inquiries were one of the reasons Bindra started looking into certain accounting issues. Bindra understood that the discount rate issue had been raised with Dodge in the past and that she had reassured the Audit Committee. Bindra wanted to determine if the discount rates had been changing in the wrong direction as the markets got worse. As a result, he asked PwC to review the Company's most recent residual interest models. The results of that analysis are set forth above.[436]

(c) KPMG

As part of its 2006 review of New Century's internal controls, KMPG had preliminarily identified as a deficiency the fact that New Century did not have supporting evidence to continue to use discount rates that had been in place the prior year. More specifically, the KPMG engagement team reiterated that Management did not have adequate documentation to support the reasonableness of the 12-14% discount rates used to value its residual interests. In addition, on December 3, 2006, Beckstrom sent Kim an e-mail with an attachment showing a $7 million impact from adjusting New Century's discount rate from 12-14% to 15%. Kim does not recall whether he requested the quantification or the request came from someone in SFG.

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[436] *See* Section VI.B.7.a.iii..

It is not clear whether KPMG ever analyzed how much New Century's residual interest valuations in quarters prior to the fourth quarter of 2006 would have changed had New Century used higher discount rates in those quarters. Donovan acknowledged that a change in the Company's discount rate could result in a "material dollar amount." But when asked if it would be necessary to reexamine previous quarters if, at year-end, the Company had decided to adjust its discount rates, Donovan responded that quarterly reviews only produce "estimated values" and that he would consider such a change a "change in estimate," not a change in accounting policy.

(d) Movement toward increasing the discount rates to 20%

By January 2007, pressure was increasing to raise the Company's discount rate to more than 15%. Concerns about the Company's residual interest discount rate were discussed at the same Board meeting at which the Company learned of the accounting errors that had occurred with respect to New Century's repurchase reserve. The minutes of the January 31, 2007 Board meeting state that, in connection with Bindra's report on matters impacting fourth quarter financial results, he reported that the other impacts included "a revised mark on the off-balance sheet residual portfolio due to updated performance assumptions and an increase in the discount rate . . . ." [437] Gotschall recalled that the residual interests were discussed at this meeting, but he could not recall any details about the discussion. He recalled, however, that there was a discussion about increasing the discount rate during the year-end audit.

It appears that, although the Company never issued its final 2006 financial statements, the Finance and Accounting Department had reached the conclusion that the Company's residual interest discount rates should be raised to 18% for the pre-2003 securitizations and 20% for the 2005 securitizations. The 2007 Hatch Memorandum, which discussed how the Company planned to revise various assumptions related to the valuation of its residual interests, shows that the new proposed discount rates for the 2005 residuals and pre-2003 residuals were expected to be 20% and 18%, respectively. [438]

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[437] Cole did not recall this discussion. Cole said that he probably did not attend the executive session of non-management directors at the January 31, 2007 Board meeting (at which there was an additional discussion of residual interest valuation) because he was not considered an independent director.

[438] *See* Section VI.B.5.c. for a discussion of the 2007 Hatch Memorandum.

Bindra wanted the 20% discount rate for these residual interest valuations to be supported by a careful weighted cost of capital analysis. Goldberg subsequently performed such an analysis at Kenneally's request. Goldberg said that, at some point in early 2007, Kenneally asked him to document the Company's decision to increase the residual interest discount rate to 20%. Goldberg has asserted that there were enough changes in the market between October 2006 and February 2007 to justify an increase from 15% to 20% in the Company's residual interest discount rates, although he could not recall specifically when some of those changes had taken place.

vii. Overview of KPMG's analysis by KPMG's concurring partner and the DPP

KPMG's analysis of the Company's residual interest discount rates was within the scope of the concurring partner review conducted by Macaulay and was included within the scope of the DPP's review in February 2007.

Macaulay's recollection is that he became aware of the discount rate issue during 2006 although he cannot recall exactly when. According to Macaulay, at some point in 2006, probably in the third quarter, he was part of a dialogue regarding the discount rates New Century was using to value its residual interests. Macaulay stated that he was not aware of recommendations to the Company from KPMG to provide documentation to support its discount rates. He indicated that, because the recommendations set forth in SFG's memoranda tend to be "rudimentary" and are merely recommendations, they would not "make it to his level." Macaulay said that, to his knowledge, at no time did SFG notify the engagement team that they were "not comfortable with" (then Macaulay corrected himself to say) "believed the residual interest account was materially misstated."

Macaulay's understanding of SFG's view was that New Century's discount rates were at the lower end of the range but that, ultimately, the engagement team concluded that the discount rate issue did not impact its ability to conclude in the quarterly reports that there was no material misstatement. Macaulay was not concerned about the residual interest valuations because the only time he would express a concern was when an error could result in a material misstatement and he did not have any concern that there was a material misstatement associated with residual interest valuations. According to Macaulay, the discount rate assumption did not have a relatively large impact on the residual interest valuations, such that concerns about those rates were not necessarily that critical to the analysis as a whole.

These statements by Macaulay seem to have no basis in fact or theory. As explained below, even small changes in a discount rate can materially affect a residual interest valuation.

Kurt Kurimsky acknowledged that, as part of his "desk review," he had read the audit assistance memoranda from SFG to the engagement team dated May 9, 2006, July 27, 2006 and November 9, 2006, each of which noted New Century's low discount rate. Kurimsky observed that SFG's data and analysis suggested that a higher discount rate might be appropriate in the absence of "additional support" by the Company for its use of a lower rate, particularly by the third quarter of 2006. Kurimsky also reviewed the Residual Interest Valuation Conclusion memoranda Beckstrom prepared for the first, second and third quarters of 2006, each of which endorsed the Company's valuation of residual interests without change to the models' assumptions.

Kurimsky acknowledged that New Century did not raise its residual interest discount rates as SFG's memoranda may have suggested, but that the engagement team's testwork was nonetheless "reasonable." In support of this conclusion, Kurimsky made two essential points: (1) the quarterly work performed by the engagement team consisted of limited "reviews," not "audits"; and (2) New Century had provided some sort of analysis in support of the discount rates they were using.

viii. The Examiner's conclusions regarding the discount rates used in New Century's residual interest valuation models

The Examiner has concluded that the 12-14% discount rates New Century used to value its residual interests during 2005 and most of 2006 should have been increased well before the fourth quarter of 2006. In fact, the Examiner concludes that New Century should have increased its residual interest discount rates before the end of 2005 to no less than 15% for its residual interests in CE securitizations and no less than 17% for its residual interests in NIMS and that, had it done so, the aggregate value of its residual interests as of year-end 2005 would have been almost $14.8 million less than New Century reported on its financial statements.

The Examiner reaches this conclusion based upon the following considerations:

- SFG consistently found that most other firms in the mortgage industry were using higher residual interest discount rates in 2005 and 2006.
- Carnahan, as the responsible SFG partner and a former audit partner of New Century, had the greatest qualifications to assess New Century's residual interest

discount rates, and he consistently expressed concerns throughout 2005 and 2006 that those rates might be too low.

- A survey of discount rates by the Examiner found that the residual interest discount rates used by other subprime mortgage lenders ranged from 15% to 21% during 2005 and from 16% to 22% during 2006.
- Kenneally's own October 2006 survey of accounting policies used by peer firms suggested that those firms used residual interest discount rates that ranged from 18% to 22%.
- We have seen no credible evidence to support the repeated assertions by some New Century officers that the Company's residual interests were subject to less risk and, therefore, merited a lower discount rate.
- The yield, as of December 31, 2005, on Ba2 RMBS pools (which Goldberg identified as a benchmark during his October 2006 analysis), plus the same risk premium that Goldberg recommended be added to that yield (200-300 basis points) would result in a discount rate of 18% as of December 31, 2005.
- New Century decided to use an 18% discount rate for its on-balance sheet securitizations in 2005.
- New Century recognized, by early 2007 that New Century's residual interest discount rates as of year-end 2006 should have been at least 18-20%.

Based on recalculations using New Century's own residual interest models, the Examiner has determined that, had New Century used discount rates of 15% (for its residual interests in CE securitizations) and 17% (for its residual interests in NIMS) as of December 31, 2005, the aggregate value of its residual interests as of year-end 2005 would have been at least $3.8 million less for New Century's residual interests in pre-2003 securitizations and $11 million less for its residual interests in the 2005 off-balance sheet securitizations. Thus, the Examiner concludes that, because New Century used unreasonably low discount rates to value its residual interests in 2005, those residual interests were over-valued on New Century's balance sheet as of December 31, 2005 by no less than $14.8 million.

The valuations of New Century's residual interests in its quarterly financial statements during 2006 were similarly inflated by New Century's continued reliance upon unduly low residual interest discount rates.

c. The Company's Failure to Reconsider Its Par Value Assumption

As previously stated, New Century's residual interest valuation models heavily depended upon various assumptions, some of which were reexamined and updated from time to time. One

assumption that New Century did not reexamine until late in 2006 was that all remaining loans in each securitization trust could be sold at par if and when that trust was terminated.

The Examiner has concluded that this par value assumption should have been reexamined and revised before the end of 2005 and that, by failing to do so New Century significantly overstated the valuations of its residual interests by at least $27.5 million at the end of 2005 and by comparable amounts during 2006.

i. New Century's "unquestioning" use of a par value assumption until late 2006

Until late in 2006, New Century consistently assumed that the mortgage loans in the off-balance sheet securitization trusts in which it held residual interests could be sold at par value when those trusts were terminated. As a result, the terminal value assumption, which related to the percentage of par value at which the mortgage loans held as collateral in the securitization trusts could be sold at termination of the trust, was set at 100% for all deals.

Although the par value assumption had important consequences for New Century's residual interest valuations, New Century did not consider changing the par value assumption in its models from 1997 or 1998 until the end of 2006, when the par value assumption was challenged as a result of information learned during the consideration of Project Kettlebell. According to Licata, the par value assumption was a "standard," "unquestioned," "inherited" assumption, which he and others in management had "overlooked" and not questioned or reexamined until late in 2006 or early in 2007. Licata could not recall any specific conversations with anyone in the Secondary Marketing Department or with anyone in the Finance and Accounting Department about the par value assumption or anyone ever questioning the par value assumption until late in 2006, nor did he recall anyone from the Board of Directors, the Audit Committee or KPMG questioning the par value assumption until late in 2006. Even in the first quarter of 2006, when 95% or more of the pre-2003 securitizations were at their termination point, no one considered that the termination values of the loans in the pre-2003 securitization trusts could be anything other than par. Licata said the Company never created a sensitivity matrix or undertook sensitivity analyses of the par value assumption, even though data showed that the assumption was likely to be invalid for loans with delinquencies ranging from 8.3% to 23%.

Licata said that in the fourth quarter of 2005 non-performing assets were still selling at a premium, which may have "subconsciously" gone into his thinking about the par value

assumption during early 2006. Licata admitted, however, that New Century may have been "lucky" in 2005 with regard to the par value assumption. His view was that, at some point in 2005, from the middle to late in the year, par was a conservative assumption, but that over the course of 2006, as home loan values deteriorated and collateral performance suffered, the par value assumption may no longer have been valid. The first time Licata thought the par value assumption may not have been "fine" would have been the middle or end of the second quarter of 2006, when New Century started to see more kickouts and scratch-and-dent pricing started to fade as well. Licata was glad that the Company decided to change the par value assumption in December 2006.

ii. John Hatch's challenges to the "par value" assumption

By the third quarter of 2006, Hatch believed that New Century was very unlikely to receive par value for the loans left in the pre-2003 securitizations when they were terminated, and he tried to make Company Management aware of this view in the course of recommending that "old" pre-2003 securitizations be terminated. Mullins agreed with Hatch's view, because he also believed the loan collateral in those trusts would have to be sold at a discount.

In October 2006, Hatch prepared an analysis of the pre-2003 residuals entitled "Pre-2003 Residuals Valuation," which he sent to Licata on October 16, 2006. In that analysis, Hatch asserted that the pre-2003 residuals were over-valued and that the par value assumption used in the residual interest models was not correct.

Hatch's October 2006 analysis was prompted by an analysis that Hatch performed during or soon after the third quarter of 2006, at the request of Garday and the tax team, which valued New Century's residual interests at maturity and not at termination. As a result of this earlier analysis, Hatch did not believe the Company's pre-2003 residuals were valued properly. According to Hatch, the analysis he did for Garday was regularly requested by the New Century tax team and had previously been provided by Licata.

Hatch said that his October 2006 residual value analysis separated the residual loans into different loan delinquency buckets and then applied market-driven "marks" to each delinquency bucket, which was far different from the method used in the residual interest valuation models, which used the par value assumption for all remaining loans. The difference in value between the two methodologies of approximately 20-30% surprised Hatch. The tax team and Licata were informed of Hatch's results and received a copy of his analysis.

Hatch transmitted his analysis of the pre-2003 residuals to Licata on October 16, 2006 with what has become known as the "Chicken Little" e-mail. Hatch used that phrase in his e-mail because, he said, it was not the first time he had raised concerns about the pre-2003 residuals with Licata. Mullins had never questioned or heard anyone question the adequacy of the par value assumption until Hatch raised those concerns with Licata. But Mullins agreed with Hatch's view that the residual loans should not have been valued at par because they would likely sell only at a discount.

Opinion said that he also questioned the par value assumption, but that "Licata truly believed in it." Opinion asked Licata if he really thought New Century could sell the remaining loans in the trusts at that price, and Licata gave Opinion several reasons why he thought that was possible. According to Opinion, Licata thought he could go into the market and get par for those loans and actually called someone to see what price he could get for those loans. Although Opinion conceded that Licata had more "market color" than he ever would, Opinion did not believe the residual interests valuation models when they invariably "spit out 100" with regard to the termination values of the loans in the collateral.

According to Hatch, Licata was not concerned about Hatch's findings because Licata believed that the "all-in value" of the residual portfolio was approximately equal to the OC value and thus reflected the economic value of the securitizations.[439] Hatch was disappointed that his views were not well received and that Licata, in particular, did not want to address the issues he had raised. Although Licata seemed to be annoyed by Hatch's persistence in arguing for the collapse of the pre-2003 deals, he told Hatch that all of the pre-2003 deals would probably be collapsed or terminated in 2007.

When interviewed during the SIC investigation, Licata did not recall ever having received or seen Hatch's October 2006 analysis or the "Chicken Little" e-mail that transmitted it. Licata claimed that he had never spoken to Hatch or anyone else about problems with the par value assumption until late in 2006, when the Project Kettlebell transaction began to raise questions about that assumption. According to Licata, there was no discussion of the par value assumption when New Century was going through the close for the third quarter of 2006.

Licata said if he had received the Hatch presentation on October 16, 2006, he probably would have said it was too soon to tell if the Company was likely to receive par or not as a

[439] Hatch disagreed with Licata's view that the residual values were correct because they equaled the OC.

termination value, but that statement absolutely would have caught his eye. Although he would have disagreed with Hatch's analysis at the time, he agreed with it in March 2007 when he was interviewed by the SIC investigators.

Licata was not the only person who did not recall seeing Hatch's presentation in October 2006. Morrice, Dodge, Bindra and Kenneally also did not recall ever having seen it or having discussed it. Kenneally said he did not recall ever seeing a presentation by Hatch that questioned the par assumption and claimed there was never a time before early 2007 that he had reason to question the par value assumption, when the subject arose during the discussion of Project Kettlebell. Kenneally acknowledged that, with the benefit of hindsight, it appears that the par value assumption was an "aggressive" assumption that should have been changed, but he did not have that belief until early in 2007.

Morrice did not speak to Hatch about collapsing the pre-2003 securitizations, although he recalled speaking with Cloyd and Licata about this topic in or about September 2006. There was some discussion of older deals that had reached their clean-up call dates and what would happen if the Company did a clean-up call. Cloyd said that it would be a bad idea to voluntarily collapse those securitizations because doing so would result in the loans coming back to New Century. Cloyd believed that the loan market was not good and that it would be better to wait for the market to improve before collapsing the securitizations. Morrice said it was implicit in his discussion with Cloyd in the fall of 2006 that collapsing securitizations would result in the Company having to sell loans released from the old securitizations for less than par value.

However, Morrice recalled that Cloyd had Credit Based Asset Servicing and Securitization ("C-BASS") analyze the potential effects of collapsing certain securitizations, and that C-BASS concluded that some loans would sell above par, some would sell below par, and some would sell at par. Morrice recalled that C-BASS found that, on average, the loans would sell for about par.

iii. Project Kettlebell changes the Company's attitude toward the par value assumption

According to Morrice, valuations of the Company's REIT portfolio by its financial advisor (a global investment banking firm) during the discussions surrounding Project Kettlebell caused New Century to realize that the par value assumption upon which it based its residual interest valuations might be incorrect, because there was a "disconnect" between the par value assumption and its financial advisor's valuations. Morrice recalled that New Century discovered

this disconnect around January 2007. According to Sanchez, one of the reasons that Project Kettlebell fell apart was because Carrington Capital's valuation team changed the value of New Century's residuals from par to 95.

Licata said the par value assumption only started being questioned in connection with Project Kettlebell because the Company had become more interested in determining what its assets were worth and about alternative ways to value those assets. They learned that delinquent loans held in inventory were becoming worth less and less. What the Company was learning about the values of the loans it held in inventory led to a rethinking about how it should value its residual interests as well. The Company began to recognize that the market value of these residual interests was largely a function of what the collateral was worth. Consequently, the Company decided that the way it should value these deals was that as soon as a deal approached or hit its termination point or clean-up call, the Company would try to assess the market value of that collateral, rather than assume it could be sold at par.

iv. New Century's departure from the par value assumption in February 2007

As explained in the 2007 Hatch Memorandum, in connection with the preparation of its December 31, 2006 financial statements, New Century revised and adjusted certain assumptions used to value its residual interests to take into consideration current market conditions and the likelihood that the terminal values of the mortgage loans in the securitization trusts would be less than par value at the clean-up call date.[440] New Century changed the terminal values for its residual interests, acknowledging that the new values were intended to take into consideration the delinquency status of the underlying loans, and to "better reflect a more reasonable expectation of collateral value at the point of termination, accounting for delinquent and non-performing loans in the pool at the time of settlement."

The February 2007 Hatch Memorandum explained that the proposed change to the par value assumption for the pre-2003 residual interests was to determine terminal value as the greater of the whole loan prices of the remaining loans (in light of their delinquency statuses) less the value of any remaining outstanding bonds and zero. According to the memorandum, the Company changed its methodology with respect to the terminal value for 2006 based on the following:

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[440] *See* the discussion of the 2007 Hatch Memorandum in Section VI.B.5.c.

> Prior to the current quarter, it was assumed that all deals would be terminated at their optional termination point, which usually occurs when the collateral pool falls below 10% of its original balance at the time the deal is settled. Furthermore, it was assumed that the collateral purchased out of the security at the point of termination would be sold at par. Recent experience relative to the recently terminated 2003-NC1 security, recent downward trends in whole loan prices, as well as current delinquency levels in some of our more seasoned securities indicated that selling terminated collateral at par might be an unsupportable expectation.

The new calculation was intended to take into consideration the delinquency statuses of the underlying loans, which provided a "weighted average whole loan price for the entire pre-2003 portfolio of assets of only 91.84 at December 31, 2006."

The underlying methodology employed by Hatch in February 2007 to determine the appropriate terminal collateral values as of December 31, 2006, was to segregate the remaining loans in each pre-2003 securitization trust into the following categories based on their delinquency statuses:

- Current
- 30 days delinquent
- 60 days delinquent
- 90 days delinquent
- Foreclosure
- Real estate owned ("REO")

Hatch then applied an expected terminal value to each loan delinquency category based on loan prices used by the Company in its LOCOM analysis. Those loan prices were, respectively: 101, 95, 80, 75, 60, and 60. Through this approach, Hatch determined a terminal value for the loans in each trust. For the 2005 NIMS, Hatch used a terminal par value of 98.[441]

According to the 2007 Hatch Memorandum, through the use of the foregoing methodology, the Company reduced the terminal values of the loans in the pre-2003

[441] The Examiner observes that Hatch's approach considered the delinquency statuses of the loans in the securitization trusts as of December 31, 2006, rather than the projected delinquency statuses of those loans at the date the trusts were expected to be collapsed. While this approach may not have had a significant effect on the calculated terminal values Hatch used for the pre-2003 residual interests (given that New Century was planning to collapse these trusts within the next six to eight months), using the projected delinquency statuses as of the date the trusts were expected to be collapsed would likely have led him to estimate lower terminal values for the 2005 NIMS because those deals were not expected to be collapsed for a number of years, and the terminal values of those loans as of the collapse date would probably have been significantly less than 98.

securitizations to less than an average of 92% of par as of December 31, 2006. According to Cloyd, this change in the terminal value assumption in the first quarter of 2007 was the most significant change the Company had made to the residual interest valuation models in years.

It does not appear that anyone at KPMG ever raised a question about New Century's reliance upon the par value assumption until early 2007. Neither Kenneally nor Licata could recall any discussion of the par value assumption with KPMG in or before 2006. Indeed, during his interview, Carnahan appeared to mistakenly assume that New Century had no choice but to assume that the terminal values in their off-balance sheet securitizations would be equal to par because, Carnahan assumed, no one would collapse a securitization if they could not sell the loans for par.

v. The Examiner's conclusions regarding New Century's failure to change par value assumption prior to the end of 2006

The Examiner has concluded that assuming that the terminal values in its residual interest valuation models would always be equal to par was fundamentally wrong and that, at a minimum, New Century should have used a valuation methodology, similar to the "delinquency bucket" method used by Hatch in 2007 to determine terminal values of the loans in its off-balance sheet securitizations before 2006.[442] In fact, the Examiner concludes that, had New Century used that terminal valuation methodology as of December 31, 2005, the aggregate value of its residual interests as of year-end 2005 would have been no less than $27.5 million less than New Century reported on its financial statements.

The Examiner reaches this conclusion based upon the following considerations:

- The fact that neither the appropriate people within the Secondary Marketing Department nor anyone within New Century's Accounting and Finance Department even questioned, much less reviewed, the propriety of the par value assumption for a period of eight or nine years, even though Warren Licata and others working in the Secondary Marketing Department understood the importance of that assumption.

[442] As noted previously in the discussion of New Century's models, there were modeling errors that related to the par value assumption. For example, the calculation taking into consideration the par value assumption appeared to differ from model to model. In this regard, the calculation for model 00NCB appears to be inaccurate since a reduction in the terminal par value percentage has the effect of increasing the value of the residual interest. *See* Section VI.B.7.a.iii. In addition, the Examiner's limited review of New Century's residual interest valuation models for the 2005 off-balance sheet securitizations identified an error relating to how these models used the terminal par value assumption. *Id.*

- Evidence that Company Management was aware of changing market conditions as early as 2005 that should have encouraged them to adjust the terminal value of the loans in its off-balance sheet securitizations. By contrast, there is no support for Licata's position that New Century was "lucky" that the par value assumption remained viable at the end of 2005.
- The Company's recognition, in February 2007, that it needed to reduce the terminal value of the loans in its residual interest valuation models to less than an average of 92% of par as of December 31, 2006.
- New Century could have and should have applied the same "delinquency bucket" methodology prior to 2006.

Based on recalculations using New Century's own residual interest models, the Examiner has determined that, had New Century used the same "delinquency bucket" methodology for assessing terminal values of the loans in its off-balance sheet securitizations as of December 31, 2005 as the Company planned to use for its 2006 financial statements,[443] the aggregate value of its residual interests as of year-end 2005 would have been at least $24.3 million less for New Century's residual interests in pre-2003 securitizations and at least $3.2 million less for its residual interests in 2005 off-balance sheet securitizations.[444] Thus, the Examiner concludes that, because New Century unreasonably relied upon the par value assumption to value its residual interests in 2005, those residual interests were over-valued on New Century's balance sheet as of December 31, 2005 by no less than $27.5 million.

The valuations of New Century's residual interests in its quarterly financial statements during 2006 were similarly inflated by New Century's continued reliance upon the par value assumption.

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[443] *See* Section VI.B.7.c.iv.

[444] The Examiner segregated loans based on the delinquency methodology that Hatch used in February 2007, although using the buckets as at December 31, 2005, as well as the same whole loan prices for those delinquency categories. The Examiner determined that those loan prices had not changed significantly between December 31, 2005, and December 31, 2006, by considering the loan prices reflected on the Company's loan trial balance as of December 31, 2005. The blend of all individualized securitization terminal values as of December 31, 2005 was 92.86, as compared to the 91.84 blended terminal value Hatch computed as of December 31, 2006. For New Century's 2005 securitizations, the Examiner used a terminal collateral value of 98, even though, for the reasons set forth above, it is likely that, as a terminal value, a price of 98 is probably too high. Had the Examiner used a lower terminal value for the 2005 NIMS, the calculated valuations of those residual interests would have been reduced and the minimum overstatement of those valuations by New Century would have been larger.

d. The Company's Repeated Decisions to Postpone the Clean-Up of Older Off-Balance Sheet Securitizations by Arbitrarily Changing Clean-Up Call Percentages

New Century routinely (and without explanation or support) reduced the clean-up call percentages in its older residual interest models, thereby pushing out the termination (or collapse) dates of the corresponding securitizations. This practice had the effect of changing the values of certain residual interests. In addition, if the Company had elected to collapse the trusts on their originally scheduled call dates, it may have learned whether the loans remaining in those trusts could in fact be sold for par value.

i. The clean-up call percentage assumptions in each residual interest valuation model

Off-balance sheet securitizations generally have a short average life but have a "long tail," which means that the majority of the loans in a securitization are paid off quickly but a certain percentage takes longer to pay off. As a general matter, when the unpaid principal balance ("UPB") of loans in a securitization trust fell to 10% or less of the value of the original collateral pool, the Company had the option to collapse the securitization by calling the trust's remaining notes, paying all bondholders, disposing of the trust, taking back any remaining balance in the OC account, and purchasing the remaining loan collateral in the securitization trust.[445] This option or call feature was often referred to as the clean-up call percentage.

Collapse of a securitization normally was mandatory when it held 5% or less of the securitization's original collateral and, as a result, discussions about collapsing a securitization often occurred when the collateral left in the securitization was in the range of 5-10% of the original collateral pool. But each residual interest valuation model contained an assumption that the corresponding securitization trust would be collapsed (*i.e.*, the clean-up call would be exercised) when the UPB in the trust reached the optional clean-up call percentage – typically 10%.

ii. KPMG's concerns about New Century's changes to the clean-up call percentages

KPMG's SFG was concerned about the Company's practice of routinely changing (reducing) the clean-up call percentages in its residual interest models, which effectively pushed

[445] According to Weiss, when the volume of loans in a trust fell below a certain level (usually 10% of the original pool balance) it became uneconomic to service the loans and the Company should have been willing to clean-up the securitization and call in the trust's notes, even if New Century had to sell the remaining loans at a discount.

out the clean-up call dates. As a result, SFG recommended that the engagement team test the Company's assertion that it would terminate the securitizations at the points specified in the models and obtain support for that determination when call percentages differed from quarter to quarter.

By 2006, the UPBs in most of the pre-2003 securitizations were under 10% of the original pool balances for those securitizations and were eligible for clean up. But New Century had been pushing out the termination dates for these securitizations and was not collapsing them. Only one OBS deal (2003-1) was collapsed, and it was collapsed when the balance was well below 10%. Since the end of 2002, no pre-2003 securitization trusts were collapsed, although most of the pre-2003 trusts had UPBs that were below 10%.

SFG noted that changing the clean-up call for a securitization to a lower percentage effectively pushed out the terminal cash flows of the residual interests and changed the valuation of the residual interest associated with that securitization. Accordingly, if the Company did not intend to call securitizations when the remaining loan value reached 10% of the original loan balance, New Century should have assumed a lower call percentage in its early models.[446]

During KPMG's review work for the first quarter of 2006, KPMG learned that projected cash flows in the residual interest valuation models were higher than actual cash flows because the projected cash flows had assumed that Management would perform a clean-up call for the 2000-A residual interest, which did not actually occur.[447] This resulted in a $3 million difference in cash flow (roughly 10%). According to Beckstrom, because this difference was discovered as part of a quarterly procedure, KPMG did not evaluate the significance of that difference.

In the second quarter of 2006, Yuval Ron of SFG asked Beckstrom to look at the clean-up call percentages from the first and second quarters of 2006, which, Beckstrom noticed, had been reduced for certain residual interests. He reported this information to Ron. Beckstrom also understood that this subject would be raised on a going forward basis.

During the third quarter 2006 review, SFG observed that "[New Century] has repeatedly revised the call assumptions for the 1999-B transaction resulting in higher valuations in earlier calculations than if [it] had used the current estimate. NC's intent and ability to retire

[446] Kenneally acknowledged that KPMG had expressed the view that some of the older securitizations had not been modeled correctly from an accounting perspective, but nobody within New Century appeared to share that view.

[447] *See* the Residual Interest Valuation Conclusion Memorandum for the first quarter 2006.

outstanding seasoned issues that are below the 10% optional termination threshold should be considered when evaluating the model assumptions and the resulting residual values."

During the 2006 year-end SOX walkthrough in November 2006, Ron asked Hatch about the clean-up call percentages in the residual interest models and Hatch mentioned that he had recommended to Licata that certain older securitizations be "cleaned up," but that Management had determined not to do so. According to Hatch, KPMG was concerned that the Company's residual interest valuation models assumed that the securitizations would be collapsed at the eligible termination date (when the relevant UPB was equal to or less than 10% of the original pool balance) but, during his time at the Company, New Century had only collapsed one securitization prior to maturity. Hatch eventually agreed with KPMG, for the reasons described in his "Chicken Little" e-mail and October 2006 presentation, except he believed that securitizations with only six months left to maturity were immaterial to the overall valuation of New Century's residual interests. According to Licata, KPMG was pressuring New Century to "cleanup" older securitizations and was "giving Hatch more of a headache" because of difficulties that other KPMG clients were having.

KPMG's Summary of Internal Control Deficiencies for year-end 2006[448] included a discussion of the Company's changes in the call dates for their residual interest valuation models and identified those changes as an internal control deficiency. At his interview, Carnahan seemed to minimize this deficiency by claiming there could be legitimate business reasons for pushing out call dates, and that a lack of documentation explaining those reasons might lead to a deficiency from an internal control perspective. Carnahan also suggested that New Century may have changed its clean-up call dates more frequently than other mortgage companies because New Century had many more old deals.

Despite Carnahan's explanation, in February 2007, KPMG observed that the operating "assumption" that New Century would exercise clean-up calls within 5-6 months for certain securitizations that were past their clean-up date had been "in effect for the last several quarters and hence not valid unless new evidence is presented."

Donovan acknowledged that "the effect would be to push out the cash flows longer" and that "without seeing the calculation, I would presume that" this change would increase the values

[448] Donovan generally declined to answer questions about this document because, he said, "this is an incomplete document—we didn't finish our work," noting the handwritten "SS" across the first page, which, he stated, meant that the document had been "superseded." But this also appears to be the most recent draft KPMG prepared.

of the residual interests. Donovan stated that he never formed any suspicions about the Company's motive in this regard, nor had any discussions with anyone on the subject. Kim seemed to have little interest in or concern about New Century's habit of reducing clean-up call percentages and postponing clean-up calls. Kim did not recall whether New Century had changed clean-up call dates prior to 2006, and did not have any suspicions regarding why New Century was not collapsing its older securitizations in 2006. He said this was a subject KPMG was still addressing during the 2006 audit. Also, unlike his colleagues at KPMG, Kim asserted that a change in a clean-up call percentage could affect a residual interest valuation in either direction.[449]

iii. New Century's decisions to exercise clean-up options and to postpone trust terminations

Decisions to exercise clean-up options or to change clean-up call percentages and postpone securitization trust terminations were made by the Secondary Marketing Department, not by the Finance and Accounting Department. Although Kenneally was aware that the Secondary Marketing Department was pushing out the termination dates for certain securitization trusts in 2005 and 2006, he never had reason to question the reasonableness of the assumptions upon which they relied in making those decisions. Sanchez was aware that the Secondary Marketing Department wanted to defer certain clean-up dates, but did not seem to know why. Gotschall did not know why the Company did not collapse the pre-2003 deals that were eligible for collapse.

Although people within the Secondary Marketing Department may have discussed their decisions with others, it appears that even Senior Management relied upon the Secondary Marketing Department to decide when to "clean up" a securitization trust. Morrice recalled discussions with Cloyd and Licata in the fall of 2006 about collapsing some of the pre-2003 securitizations, and that Cloyd had expressed the view that it would be a bad idea to voluntarily collapse those securitizations because doing so would result in the loans coming back to New Century at a time when the loan market was not good.

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[449] Kim said that, at the call date, the value of the residual interest could be higher or lower than what the Company had on its books, and that by stretching out the payments, the value could be higher or lower. Generally speaking, Kim said, extending a securitization trust for a longer period could lower the value of the residual interests because there could be more loss assumptions built in and there is no prepayment income after a long period of time because prepayment penalties are paid during the earlier periods of a loan.

Practical considerations may have played a role in the decisions about when to make clean-up calls of older securitizations, along with a misunderstanding on Licata's part about the effects of postponing a clean-up call. Because he believed they had modeled the securitizations properly, he did not think that pushing out the clean-up calls would have an impact on anything. Because clean-up calls required a lot of time and effort, Licata "figure[d] they would push them out until they had time to do them." While Licata claimed that the practice of reducing the clean-up call percentages did not impact the value of the residual interests,[450] the KPMG staff we interviewed and commentary in the KPMG working papers contradicted Licata's assertion.

According to Licata, in November or December 2006, "the Company" decided to collapse the pre-2003 securitizations in 2007 because, Licata said, it was "time to do so." Although Licata acknowledged that ALCO was the proper committee to approach for permission to collapse the pre-2003 residuals, he never approached ALCO in 2006 to request such permission. Licata did not recall whether anyone on ALCO approached him to discuss collapsing the pre-2003 residuals. In the fourth quarter of 2006 or the first quarter of 2007, Licata put a summary together that contained scenarios for collapsing the deals and the pros and cons of selling notes or calling back collateral.

Although in his interview Carnahan suggested that an inability to obtain par might be a reason not to collapse an older securitization, Licata claimed that he had never heard anyone suggest, until after New Century went into bankruptcy, that clean-up calls might have been pushed out because otherwise the par value assumption would be revealed to be inappropriate or the Company would have taken a "big hit" because it could not sell the residual loans at par. Nobody ever indicated to Kenneally that New Century tried to defer clean-up dates to mask the inappropriateness of the par value assumption.

iv. Failure to appreciate the accounting consequences of changes in the clean-up percentage assumptions in the models

Decisions about when to exercise clean-up calls and to terminate securitization trusts may have been influenced by business, tax or economic considerations. But how those decisions affected the clean-up call percentages in the residual interest valuation models created

[450] *See* Section VI.B.7.d.iv.

accounting issues. Licata's explanation for how the relevant model assumptions were changed suggests that he did not fully appreciate those accounting consequences.

For instance, during his interviews by the SIC's investigators, Licata said that when each off-balance sheet securitization was created, the relevant residual interest valuation model would assume, at the outset, that the clean-up call would be exercised when the UPB was 10% of the original loan collateral. According to Licata, this was "a mathematical determination." When a trust came close to the 10% UPB trigger, if the Company was not ready to collapse the trust, Licata or his team would just change the percentage required to terminate the trust and push the deal out further.

Licata's rather cavalier attitude toward changing a basic assumption in the residual interest valuation model appeared to rest upon his mistaken view that changing the clean-up percentage or the termination date was "not really going to matter" because the assets remaining in the trust upon termination would continue to be valued at par. If Licata truly believed this, then he failed to appreciate that, by pushing out the trusts' termination dates, he was also changing the cash flows being valued by the residual interest valuation models and, thereby, changing the valuations of the residual interests on New Century's financial statements.

v. The Examiner's conclusions with regard to New Century's changes in the clean-up percentages in its residual interest valuation models

The Examiner has concluded that the responsible people within the Secondary Marketing Department at New Century did not appreciate the accounting implications of their frequent and unsupported changes in the clean-up call percentages upon which their residual interest valuation models relied. Licata, who appeared to control changes to this assumption, was fundamentally mistaken in thinking that changes in that percentage would not affect the valuations of New Century's residual interests. As a result, changes that he regarded as ministerial or "mathematical" were producing unappreciated consequences in terms of the accounting for New Century's residual interests.

Unfortunately, the Examiner is not in a position to assess the quantitative impact of the changes being made in the models' clean-up call percentages. The Examiner did not find any evidence, however, that these changes were intended to achieve significant increases in New Century valuations.

e. New Century's Residual Interest Valuations Were Adversely Affected by Problems with the Prepayment and Loss Assumptions Upon Which the Company's Models Relied and the Failure to Update Those Assumptions in an Appropriate Manner.

As previously described, each of the New Century residual interest valuation models was based on a large number of assumptions (potentially up to 100). Each deal had different assumption curves.

The original assumptions used in New Century's models came from Kontoulis, New Century's original head of the Secondary Marketing Department, based upon his past industry experience. Everyone agreed that New Century's residual interest valuation models were only as good as the assumptions upon which they relied, that these assumptions required exercises of judgment, that the assumptions in the models needed to be updated from time to time to keep the models accurate and consistent with market trends, and that there were frequent discussions within New Century and with KPMG about those assumptions. But the Examiner's investigation revealed misunderstandings and disagreements about the sources of certain key assumptions, the processes by which they were determined, and the frequency with which they were updated. These misunderstandings and disagreements were particularly acute for the models' assumptions regarding prepayments and expected losses, which were the two assumptions most likely to have the greatest impact on the cash flows into the residual interest models.

i. The prepayment rate assumptions in New Century's residual interest valuation models

The residual interest valuation models attempted to predict the rate at which borrowers would repay the mortgage loans held in the securitization trust collateral. To do this, the models relied upon a prepayment rate assumption, known as the CPR, as a predictor of how fast all loans in the trust pool would be repaid. The CPR was a key assumption in the residual interest valuation models, because prepayments of loans not only removed those loans — and their cash flows — from the relevant trust's collateral, but also could result in the trust's receipt of prepayment penalty income.[451] The CPR attempted to estimate both voluntary prepayments (*e.g.*, in connection with sales and refinancings) and prepayments associated with foreclosures and defaults.

[451] Prepayment penalty income generally is applicable only within the first two years of a loan.

Prior to December 2006, the Company generally based its CPR assumptions on the average historical performance of its collateral from 1997 to 2002. According to Hatch, the Company used the 1997-2002 time period in an attempt to be "conservative" in predicting prepayment speeds because this was before the "spike" in mortgage volume that led to higher prepayment speeds and lower losses.

A number of people have criticized the CPR assumptions used in New Century's residual interest valuation models, often in inconsistent ways. For example, Mullins said that New Century sometimes understated and sometimes overstated the CPR. According to Morrice, however, the biggest error in the assumptions used in the residual interest valuation models was the underestimation of prepayment speeds.

Hatch said it was "problematic" that the CPR combined voluntary and forced prepayments. He also considered it a problem that the prepayment penalty projection was calculated on a static unpaid principal balance that did not reflect prepayments, so that if the prepayment percentage increased, New Century's values would not accurately reflect the impact of those prepayments. According to Hatch, to refresh static data with actual dynamic data was too difficult using New Century's Excel-based models.[452]

ii. KPMG's concerns about New Century's prepayment rates and the responses of the Secondary Marketing Department

KPMG believed the CPR assumptions should have been changed by New Century more often as a result of the divergence between actual and projected results. Based on their analysis of the models tested each quarter, KPMG's SFG consistently recommended to the KPMG engagement team that they analyze New Century's CPR assumptions because the CPR assumptions were considered "low compared to those of similar issuers, the prepayment performance in the industry, and the Pool's historical performance." A low CPR assumption would mean that the corresponding residual interest would be overvalued.

Kim acknowledged that New Century's CPR assumptions were a topic of discussion with New Century. A chart in the KPMG workpapers documented the variances between projected and actual conditional prepayment rates. The fact that all the variances, except one, are negative indicates that the actual prepayment speeds were faster than what New Century had originally

[452] On the other hand, Hatch said the CPR limitations in the models were not significant because he could check the numbers with the trustee statements and come close to "tying" them out.

forecasted. Although the KPMG workpaper discusses the fair value adjustment that New Century needed to make in the second quarter of 2006 to bring New Century's recorded values in line with the actual fair values of the residual interest, Kim stated that faster prepayment speeds do not necessarily result in a write-down of a residual interest because there may be other assumptions in the model going in the opposite direction so the net effect could be different. Given the other factors that might influence residual interest valuation, Kim said that it would be inappropriate to say the fair value adjustment recommended in the KPMG workpaper was primarily the result of the change in prepayment rate, but he admitted that the change in the CPR could certainly be part of the reason for that adjustment.

New Century declined to change the CPR assumptions as frequently as suggested by KPMG. At least in part, this may have been because KPMG did not support its view with market information and the Secondary Marketing Department apparently believed that Kim did not understand secondary marketing. Furthermore, according to Hatch, KPMG was not as concerned with the Company's assumptions about prepayment rates or loss curves as it was about the Company's residual interest discount rates and its repeated decisions to postpone the collapse of older securitizations and, therefore, may not have pressed the Company as hard on the CPR issue.[453] Walker did not recall any discussions with KPMG regarding the CPR curve or loss assumptions used to value residual interests.

New Century's CPR assumptions were discussed at the September 5, 2006 meeting between KPMG and New Century representatives that we have discussed previously. According to Goldberg's memo describing that meeting, Carnahan told New Century that its CPRs were slower than those of other companies with which he worked. At his interview, Carnahan tried to minimize this statement by saying that New Century had always been "pretty good" at estimating prepayment speeds and that, although New Century's CPRs were slower "on the tails" of older securitizations, that weakness was "offset" by the fact that the Company was historically "very accurate" in predicting prepayment speeds and cash flows at the "front part" of the curve. According to Carnahan, his purpose at the September 5 meeting was to stress New Century's need to document its CPRs better to avoid "risks." Carnahan also claimed that Goldberg's memorandum of the September 5 meeting did not accord with his recollection to the extent it

[453] According to Hatch, KPMG was more concerned about the Company's discount rate assumptions and the assumption that the deals would be collapsed at the eligible termination level rather than maturity (since history had shown that NCF only collapsed one deal prior to maturity).

suggested that he had described New Century's CPRs as generally "slow" or inappropriate and, therefore, in need of adjustment. He also disagreed with any suggestion that there had been a disagreement between him and KPMG on matters related to CPRs.

Despite what Carnahan said at his recent interview, KPMG's workpapers indicate that New Century continued to use prepayment rates throughout 2006 that were lower than the SFG considered to be appropriate. As part of their work on the incomplete 2006 audit, KPMG learned that, once again, actual prepayment speeds were faster than had been anticipated by the estimates used in the residual interest models.

Apparently, the key people in the Secondary Marketing Department who largely controlled the assumptions in the residual interest valuation models believed the increase in prepayment speeds and decline in delinquencies and losses experienced in 2003 and 2004 were unique to the market conditions at the time (for example, low interest rates, abnormal housing price appreciation). This reluctance to make changes in reaction to current events was summed up in the following description, by Mullins, of Licata's view that a change in "one quarter was an anomaly, [a change that lasted] two quarters we pay attention [to], and [if a change lasted] three quarters we [would] make a change" in the models' assumptions. Because of this reluctance to adjust its prepayment assumptions, when the mortgage market trended downward in 2005, New Century failed to adjust its prepayment assumptions to reflect then-current market conditions.

iii. New Century's change in its prepayment assumptions in early 2007

New Century did not change its prepayment assumptions until early 2007 when New Century changed, as of December 31, 2006, the prepayment rate assumptions that applied to the residual interest valuation models for its 2005 off-balance sheet securitizations. The February 2007 Hatch Memorandum explains that this change came about as a result of the following:

> Prior to the current quarter, baseline prepayment speeds applied to the securitization models were based on [a] combination of historic prepayment experience and management's judgment relative to current market conditions at the time the securitization settled (*please refer to the quarterly Residual Asset Valuation Report and the Securitization Valuation Methodology Memo for a comparison of historic prepayment speeds relative to the baseline CPR assumptions*). These prepayment speeds, being based on market averages were not adjusted for changing market conditions and required periodic management review to determine if and when changes in modeled speeds were appropriate. Furthermore, they were not reflective of loan specific collateral characteristic in

each individual securitization either at the point of security settlement or over time.

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For future valuation purposes it was determined that the baseline prepay speeds in the Pricing Model would provide a more logical basis for determining projected prepayment speeds via conditional prepayment rates (CPR). The rationale for this change is based on the fact that the pricing model is consistently updated to reflect values in the current whole loan market and more recent market views on speeds."

In other words, it took until February 2007 for New Century to recognize that its previous approach for determining prepayment speeds — based on historic experience from several years before (1997-2002) — should be jettisoned in favor of using CPR data in a pricing model that New Century consistently updated on a current basis.

iv. The Examiner's conclusions with regard to New Century's use of improperly low prepayment rate assumptions in its residual interest valuation models

The Examiner has concluded that the Company should have been calibrating the prepayment assumptions in its residual interest valuation models to reflect changing market conditions much earlier than 2007.

Based on an analysis of the variances between the CPR assumptions in New Century's residual interest models and actual prepayment results, the Examiner has determined that, despite evidence of changing market conditions during 2005, New Century did not materially adjust its modeled CPR assumptions to reflect the then-current market conditions and, as a result, consistently under-forecasted its projected prepayments. *See* Table A on the following page. In fact, while projected prepayments were generally lower than actual results, the Examiner observed that New Century made changes to its CPR assumptions — up until the first quarter of 2006 — that tended to *reduce* the modeled prepayment rates, *i.e.*, made changes that moved the models in the *wrong* direction. If New Century's residual interest valuation models consistently relied upon unduly low CPR assumptions, then the residual interest valuations they produced were consistently overstated.

TABLE A
New Century Financial Corporation
Quarterly Prepayment Variance ($)

	03/31/2004	06/30/2004	09/30/2004	12/31/2004	03/31/2005	06/30/2005	09/30/2005	12/31/2005	03/31/2006	06/30/2006	09/30/2006	12/31/2006
99NC1	(9,073)	816,044	696,992	1,220,435	1,850,076	1,644,240	1,313,624	864,945	1,086,765	770,263	366,069	673,658
	0%	13%	14%	43%	70%	69%	62%	45%	61%	48%	25%	50%
99NC2	203,931	1,194,844	230,478	736,321	660,035	1,037,536	(11,831,975)	352,588	505,277	943,462	(137,137)	282,590
	7%	45%	15%	73%	72%	125%	-88%	55%	86%	180%	-31%	66%
99NC3	390,341	187,917	2,636,008	1,553,829	604,187	1,408,770	(14,343,869)	109,037	802,065	(10,217,094)	(9,519,963)	908,590
	10%	6%	131%	125%	55%	142%	-90%	14%	110%	-86%	-93%	176%
99NC4	(173,918)	2,417,189	1,601,907	2,982,088	2,420,104	1,550,340	2,842,750	2,004,131	(23,957,693)	(21,519,288)	1,629,511	591,770
	-3%	40%	35%	110%	101%	73%	148%	121%	-89%	-90%	140%	58%
99NC5	204,990	(88,411)	217,889	184,529	318,144	193,951	332,515	325,952	207,013	226,704	179,914	27,033
	31%	-16%	68%	64%	127%	100%	197%	401%	391%	196%	174%	30%
99NCA	(904,734)	1,136,260	1,273,994	4,153,237	539,679	1,399,422	2,405,326	900,521	656,500	589,468	742,679	333,982
	-13%	18%	23%	114%	22%	61%	146%	62%	49%	47%	64%	32%
99NCB	(1,141,841)	3,367,559	1,390,421	4,520,813	2,807,990	3,125,057	2,085,371	(40,597,248)	362,386	352,600	249,981	212,391
	-12%	38%	19%	98%	81%	101%	76%	-93%	16%	17%	13%	12%
99NCD	(1,596,060)	622,709	(388,898)	1,877,953	1,384,887	1,636,735	1,469,656	810,766	1,088,982	95,363	16,369	(502,183)
	-29%	12%	-10%	79%	65%	85%	115%	53%	79%	8%	1%	-46%
00NC1	(1,208,456)	1,522,648	3,355,968	187,821	3,316,889	4,035,026	2,646,165	2,394,729	929,135	1,710,505	608,290	1,117,833
	-13%	18%	103%	3%	128%	242%	184%	188%	83%	164%	66%	129%
00NCA	(1,157,907)	1,056,077	1,932,406	889,409	1,661,773	746,886	1,447,405	2,740,476	(18,142,872)	196,384	648,551	457,879
	-24%	30%	76%	46%	96%	48%	136%	286%	-92%	27%	94%	72%
00NCB	891,481	2,233,920	2,925,205	3,012,494	2,669,203	2,102,557	1,735,680	751,370	1,097,187	1,564,298	365,395	1,000,948
	12%	39%	77%	111%	117%	110%	106%	54%	88%	140%	38%	112%
01NC1	1,477,486	4,029,337	3,502,509	1,968,927	4,321,296	1,224,466	3,612,984	1,570,492	3,130,922	2,057,705	1,180,792	265,659
	12%	36%	37%	33%	94%	37%	121%	92%	204%	158%	104%	26%
01NC2	12,617,011	6,496,638	(118,185)	4,608,252	2,914,010	4,076,268	4,844,119	4,703,099	3,538,717	1,389,735	2,227,666	3,484,991
	60%	38%	0%	43%	38%	70%	145%	196%	170%	76%	134%	235%
02NC1	10,114,565	10,304,048	(2,078,703)	2,398,655	1,874,566	951,717	3,198,657	1,182,668	2,561,573	340,809	861,557	575,117
	49%	85%	-16%	41%	58%	42%	335%	163%	396%	71%	201%	167%
02NCA	(768,165)	11,016,173	3,494,090	1,265,842	2,764,439	6,037,342	6,002,630	5,692,113	5,832,673	6,473,150	3,752,511	2,925,530
	-1%	24%	10%	6%	20%	56%	78%	107%	141%	179%	120%	106%
05NCA								(3,702,770)	(5,892,952)	(4,126,887)	(5,713,714)	(13,283,234)
								-11%	-12%	-7%	-9%	-23%
05NCB								6,588,343	36,454,210	45,115,890	(2,611,571)	(9,072,187)
								21%	63%	56%	-2%	-6%
05NCC									25,586,073	51,596,082	13,583,956	(5,958,806)
									65%	82%	11%	-4%
05NCD									22,241,784	36,539,135	4,415,612	(7,026,661)
									73%	76%	5%	-6%

*Positive numbers mean that actual results were higher than projected results.

For the reasons set forth above, it does not appear that the Company's use of improper prepayment assumptions could be characterized as inadvertent. To the contrary, New Century's failure to adjust its prepayment rates to reflect changing market conditions was contrary to the advice it consistently received as far back as the first quarter of 2005 from KPMG's SFG, which repeatedly expressed concern about the Company's use of low prepayment speed assumptions. In fact, the changes made to prepayment assumptions that are described in the 2007 Hatch Memorandum seem consistent with what KPMG's SFG had been recommending for years before that time.

Not only did New Century wait too long to make appropriate changes to its prepayment assumptions in the models for its residual interests in the 2005 off-balance sheet securitizations; it does not appear that New Century made comparable adjustments in 2007 to the prepayment assumptions in the models for its pre-2003 securitizations, even though the value of those pre-2003 residual interests was approximately $133.4 million at December 31, 2005, representing roughly 56% of the total residual interests recorded by New Century.

v. The loss assumptions in New Century's residual interest valuation models

The residual interest valuation models also attempted to predict the rate at which the securitization trusts would suffer losses on the mortgage loans held as collateral. To do this, the models relied upon loss curves that attempted to predict the extent to which the trusts would suffer losses over the life of the trust. Actual losses were populated into the models each quarter, and projected losses were expressed as an annualized percentage of the outstanding balance.

According to Morrice, New Century determined the appropriate loss curves by calling various Wall Street firms to gather data. Morrice said there was some concern about the way in which New Century determined its loss curves and some people (not clear who) wanted a better procedure for determining this assumption, but no one could think of anything better.

Hatch said that New Century's loss curves were not up to industry standards because they did not include the conditional default rate ("CDR") and "loss severity" (the probability of loss) functions that were available in most third-party valuation tools. This was a problem with both Licata's models and Hatch's models.

Just like New Century's CPR assumptions, and for similar reasons,[454] the loss curves New Century used in its residual interests valuation models prior to December 2006 were based on historical averages of loss experience associated with its loan collateral as of the 1997-2002 time period.

vi. KPMG's concerns about New Century's loss curves and the responses of the Secondary Marketing Department

KPMG argued that New Century should have changed its loss curve assumptions more frequently, because of the divergence between actual losses suffered by the trusts and the losses that New Century's models were projecting. As was true with prepayment rates, however, KPMG seemed not to give as much emphasis to its concerns about New Century's loss curves as it gave to other residual interest matters, like discount rates and collapse dates. As a result, the Secondary Marketing Department appeared to follow Licata's view that the Company should not change its loss assumptions unless there had been an actual trend suggesting a change that lasted for at least three quarters.

vii. New Century's change in its loss assumptions in early 2007

New Century did not change its loss assumptions until early 2007 when New Century changed, as of December 31, 2006, the loss rate assumptions that applied to the residual interest valuation models for its 2005 off-balance sheet securitizations. The February 2007 Hatch Memorandum explains that this change came about as a result of the following:

> Prior to the current quarter, baseline loss assumptions applied to the securitization models were based on [a] combination of historic loss experience and Secondary Marketing management's professional judgment relative to current market conditions at the time the securitization settled (please refer to he quarterly Residual Asset Valuation Report for a comparison of historic losses relative to the baseline loss vectors).
>
> The methodology for determining losses in the company's Pricing Model is significantly different from our existing securitization models. The Pricing Model bases losses on a loan level loss allocation based on credit grade and then updated for the loan level characteristics and distributed by a defined schedule over the life of the loan as of inception.... To measure the adequacy of our current historically based loss assumptions, and consistent with the Kettle Bell [sic] analysis, each deal's modeled loss expectations was evaluated against current delinquencies and actual loss performance to date to determine if an adjustment to

[454] *See* Section VI.B.7.e.i. above.

the existing loss assumptions was required. In addition, recent loss trends were evaluated to determine if the calculated historical and delinquency based factor adjustments made sense relative to recent and expected experience.

As in the case of its CPR assumptions, it took until February 2007 for New Century to recognize that its previous approach for determining loss curves — based on historic experience from several years before (1997-2002) — should be jettisoned in favor of using much more recent data.

viii. The Examiner's conclusions with regard to New Century's use of improperly low loss assumptions in its residual interest valuation models

The Examiner has concluded that the Company should have been calibrating the loss assumptions in its residual interest valuation models to reflect changing market conditions much earlier than 2007.

Based on an analysis of the variances between the losses that New Century projected and the losses actually incurred by its pre-2003 securitizations, the Examiner has determined that actual losses generally were consistently higher than projected losses. *See* Table B on the following page. This suggests that the Company may not have been adjusting its loss rate assumptions to reflect market conditions and, as a result, was consistently under-forecasting its losses. If New Century's residual interest valuation models consistently relied upon unduly low loss projections, then the residual interest valuations they produced were consistently overstated.

Not only did New Century wait too long to make appropriate changes to its loss assumptions in the models for its residual interests in the 2005 off-balance sheet securitizations, it does not appear that New Century made comparable adjustments in 2007 to the loss assumptions in the models for its pre-2003 securitizations.

TABLE B
New Century Financial Corporation
Quarterly Loss Variance ($)

	03/31/2004	06/30/2004	09/30/2004	12/31/2004	03/31/2005	06/30/2005	09/30/2005	12/31/2005	03/31/2006	06/30/2006	09/30/2006	12/31/2006
99NC1	(53,004)	411,581	371,420	279,412	750	300,325	402,673	241,363	229,111	143,018	37,779	505,044
	-13%	*98%*	*196%*	*211%*	*1%*	*809%*	*1225%*	*1469%*	*1566%*	*155%*	*45%*	*670%*
99NC2	(178,041)	45,751	32,525	(17,052)	(40,605)	(24,475)	136,437	136,913	131,336	48,890	21,990	(19,632)
	-77%	*21%*	*21%*	*-18%*	*-69%*	*-79%*	*510%*	*1325%*	*1376%*	*141%*	*73%*	*-72%*
99NC3	14,212	89,990	263,881	232,401	30,939	133,735	74,706	140,393	214,989	139,836	171,773	248,669
	5%	*38%*	*233%*	*299%*	*59%*	*625%*	*714%*	*2523%*	*4222%*	*4634%*	*12250%*	*6873%*
99NC4	(131,580)	89,042	216,091	(9,496)	2,609	745,769	376,764	209,121	296,032	308,826	346,605	125,633
	-32%	*23%*	*60%*	*-3%*	*1%*	*951%*	*1113%*	*738%*	*3373%*	*1410%*	*1809%*	*782%*
99NC5	204,990	(88,411)	217,889	184,529	318,144	193,951	332,515	325,952	207,013	226,704	179,914	27,033
	31%	*-16%*	*68%*	*64%*	*127%*	*100%*	*197%*	*401%*	*391%*	*196%*	*174%*	*30%*
99NCA	(20,211)	439,826	203,347	282,878	177,210	85,520	315,046	249,918	140,461	100,680	20,065	171,622
	-5%	*115%*	*83%*	*159%*	*133%*	*138%*	*697%*	*646%*	*402%*	*319%*	*71%*	*683%*
99NCB	(9,005)	557,956	86,522	59,956	305,888	424,572	304,325	188,390	386,956	309,467	173,214	151,990
	-2%	*106%*	*25%*	*21%*	*124%*	*255%*	*225%*	*586%*	*925%*	*833%*	*519%*	*496%*
99NCD	304,655	186,050	184,756	200,473	23,551	251,726	162,661	221,369	382,165	77,974	249,598	75,162
	219%	*158%*	*215%*	*261%*	*47%*	*899%*	*942%*	*1647%*	*3148%*	*721%*	*2560%*	*836%*
00NC1	414,750	878,370	338,977	670,476	999,485	1,176,550	384,340	652,930	363,830	342,698	336,782	525,796
	66%	*161%*	*76%*	*632%*	*1359%*	*3100%*	*1275%*	*3949%*	*2516%*	*2932%*	*3296%*	*5829%*
00NCA	23,723	185,244	378,123	309,517	95,333	288,010	236,556	231,159	513,416	273,794	165,642	91,465
	14%	*122%*	*287%*	*669%*	*306%*	*1140%*	*1120%*	*1805%*	*6566%*	*2608%*	*1764%*	*1129%*
00NCB	114,500	(20,677)	496,893	8,988	282,784	317,204	128,353	196,705	235,200	211,975	61,073	180,014
	38%	*-8%*	*249%*	*7%*	*278%*	*467%*	*246%*	*447%*	*613%*	*635%*	*206%*	*680%*
01NC1	274,850	460,708	101,158	(468,162)	334,946	(104,346)	164,993	64,654	198,746	221,339	114,505	346,447
	80%	*102%*	*23%*	*-123%*	*107%*	*-43%*	*77%*	*55%*	*228%*	*322%*	*225%*	*965%*
01NC2	132,003	(241,209)	(38,588)	205,462	587,736	811,736	349,153	328,149	407,446	165,029	612,664	478,833
	30%	*-41%*	*-9%*	*64%*	*226%*	*399%*	*209%*	*671%*	*1323%*	*618%*	*2608%*	*2278%*
02NC1	(187,617)	167,964	(492,504)	148,312	(141,913)	(23,602)	(59,881)	(16,796)	(92,541)	(30,343)	(24,070)	(24,344)
	-65%	*53%*	*-97%*	*106%*	*-93%*	*-18%*	*-53%*	*-16%*	*-102%*	*-88%*	*-86%*	*-95%*
02NCA	(163,628)	84,786	364,109	363,632	(82,087)	166,520	364,888	143,061	599,554	492,567	1,245,918	538,173
	-14%	*7%*	*32%*	*33%*	*-8%*	*20%*	*54%*	*28%*	*150%*	*229%*	*680%*	*343%*
05NCA									56,175	65,511	(548,420)	(796,846)
											-75%	*-75%*
05NCB									6,890	57,358	133,159	84,489
												6%
05NCC									-	33,410	1,284,471	2,448,501
05NCD									-	164,529	475,599	1,570,098

*Positive numbers mean that actual results were higher than projected results.

ix. Concerns that New Century stopped updating key assumptions in its residual interest valuation models for pre-2003 securitizations

The primary reason the SIC looked more closely at New Century's accounting for residual interests was that KPMG informed the SIC in February 2007 that the Company had stopped making adjustments to its prepayment speed and loss assumptions in the models for its pre-2003 securitizations. The Examiner's investigation confirmed that this was true, *i.e.*, that New Century substantially reduced the number of adjustments to its prepayment rate and loss assumptions by the fourth quarter of 2005, and stopped making those adjustments after the first quarter of 2006, even though the value of its pre-2003 residual interests was approximately $133.4 million at December 31, 2005, representing roughly 56% of the total residual interests recorded by New Century.

According to Mullins, when he had operational responsibility for the residual interest valuation models, changes in assumptions would be made on a quarterly basis, depending on market conditions. Mullins said that he discussed possible changes in assumptions with Warren Licata before receiving authorization from Licata to make those changes. Mullins did not know whether the CPR, loss and other assumptions in the models were changed after he stopped being involved in the residual interest valuation process.

When Hatch took over responsibility from Mullins for portfolio reporting in late 2005 or early 2006,[455] the Secondary Marketing Department did not continue to update the CPR and loss assumptions in the residual interest valuation models for the pre-2003 securitizations as frequently as had been the case before,[456] even though Hatch said he did not intend to perform his portfolio reporting responsibilities differently than had Mullins. Neither Hatch nor Mullins recalls any discussion, when Hatch assumed Mullins' responsibilities, of the way that assumptions in the pre-2003 residual interest models had been updated by Licata and Mullins. It was not until early 2007 (when Hatch was asked to go back and review the assumption changes to the pre-2003 models that occurred when Mullins was in charge of portfolio reporting) that Hatch learned that Licata and Mullins had changed assumptions for the pre-2003 models more frequently before Mullins left and Hatch became responsible for portfolio reporting.

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[455] *See* Section VI.B.3.d. above.

[456] *See* the table in Section VI.B.7.e.x. below.

Hatch disclaimed any responsibility for making any unilateral decisions about assumption changes, claiming that everything he did was at the direction of Licata. Hatch said he merely rolled forward prior assumptions without questioning the assumptions themselves. Although Hatch stated that he made recommendations to Licata from time to time about changes in assumptions, he would not implement any such change without Licata's approval. According to Hatch, Licata provided him with the assumptions to use in his models and would direct Hatch to make changes in assumptions. Hatch did not change assumptions unless Licata specifically told him to do so. Hatch did not know whether Licata developed the assumptions himself or whether others had input in setting the assumptions.

According to Hatch, the only instance in which Licata directed Hatch to change an assumption occurred in late 2005 or early 2006 when Hatch changed the prepayment speeds on the 2005 models because the prepayment speeds were significantly lower than reality and the values, therefore, were inaccurate. The change involved the use of prepayment speeds based on the New Century pricing model, which frequently updated assumptions in order to tie to whole loan sales. Hatch did not consider using the pricing model's assumptions in the residual interest valuation models prior to that change in prepayment speeds.

Hatch said that he did not make monthly recommendations to change the prepayment and loss assumptions in the residual interest valuation models because the numbers were derived from historical averages and changing assumption curves every month based on actual data would skew the results more than not changing the assumptions. Further, Hatch said that Licata directed Hatch to not change assumptions because dips and spikes were temporary and the curves would return to the long-term modeled trends. Hatch agreed with this theory in the short-term (three to six months out), but also believed that changes to assumptions would be warranted if market forces changed considerably after more than six months. According to Hatch, both he and Licata believed that assumptions should not change without well-reasoned documentation. Our investigation never discovered any such documentation.

Licata was adamant that New Century did not stop updating the assumptions in the residual interest valuation models at any time, asserting that that the Company continued to update the assumptions in the models for the pre-2003 securitizations during 2006. When asked whether the Company updated the assumptions less frequently in 2006 than in the past, Licata claimed that his group followed their same procedures as they had every quarter. Licata

disagreed with KPMG's assertion that the models were not adjusted as frequently in or after 2005, claiming that KPMG's incorrect impression was based upon a miscommunication between a KPMG junior analyst and that person's contact on Licata's staff.

Licata did not recall discussing with anyone in 2005 or later that it was no longer cost-effective for the Company to update the assumptions in the models for the pre-2003 securitizations. He also did not remember discussing with anyone that, because the pre-2003 deals were getting older and the pools were seasoned, it did not make sense to revisit and update the assumptions as frequently. Licata claimed that his group was always looking at the assumptions in the models in the process of rolling them forward in an effort to determine whether they were working correctly. Licata's superiors (Cloyd and Flanagan) said they were not aware of any change in the Secondary Marketing Department's practice of updating assumptions in the residual interest valuation models for pre-2003 securitizations in 2005 and 2006, and claimed they would have disagreed with any suggestion that those assumptions not be updated as frequently as before in order to conserve resources or for other reasons.

Kenneally claimed that, although he participated in "conceptual discussions" with the Secondary Marketing Department about the assumptions in the residual interest valuation models, the Secondary Marketing Department would tell Finance and Accounting Department what assumptions were being used in the residual interest valuation models and that he did not provide the Secondary Marketing Department with any of those assumptions. According to Kenneally, the assumptions in the models were not changed each quarter. The Secondary Marketing Department would identify the changes they had made in informal discussions or e-mails (not in formal memoranda). Kenneally suspected that there may have been some discussion in ALCO meetings about the model assumptions, in which Licata, Cloyd, Hatch and Mullins participated. Kenneally said no one ever "pushed back" against the Secondary Marketing Department on these issues. Kenneally said he did not recall any change in the Secondary Marketing Department's methodology for adjusting assumptions in the residual interest valuation models, although he was aware of "hearsay" from Kim and Beckstrom in the fourth quarter of 2006 or the first quarter of 2007 that the Secondary Marketing Department had stopped changing the assumptions. Kenneally also recalled being told by KPMG that Licata or Hatch had confirmed that the Company had stopped revising the assumptions in the models for older securitizations.

It is not clear when KPMG first learned that New Century had changed its practice with regard to updating the assumptions in the residual interest valuation models for the pre-2003 securitizations. Kim does not recall when New Century stopped changing the assumptions, but that it is indicated in the KPMG workpapers. Kim was not sure whether it was year-end 2006 when he first learned that they were not changing assumptions. Kim does not recall whether the SFG specifically weighed in on the reasonableness of New Century's actions, but he stated that they would have discussed the issue with the whole engagement team, of which SFG was a part. KPMG prepared a document for the incomplete 2006 year-end audit that criticized management for not updating some of the assumptions for the older transactions. It was Kim's impression that "someone" determined that adjusting the assumptions for the older securitizations would not make a significant difference. In order to determine whether this was reasonable, either New Century or KPMG would have done some calculations. Kim could not recall who performed those calculations.

x. The Examiner's conclusions with regard to New Century's failure to update the prepayment and loss assumptions in certain of its residual interest valuation models in 2006

The Examiner has determined that adjustments to the prepayment speed and loss assumptions in those models were not made with the same frequency after residual interest valuations were calculated for the third quarter of 2005:

Quarter	Number of Adjustments	Net Impact on Residual Interests
Q2 2004	65	$2,695,777
Q3 2004	57	$4,978,679
Q4 2004	47	$2,663,239
Q1 2005	48	$2,487,804
Q2 2005	39	$2,020,927
Q3 2005	43	$2,658,385
Q4 2005	6	$747,161
Q1 2006	14	$101,230

The Examiner has concluded that New Century should have continued to update the CPR and loan loss assumptions in the valuation models for its residual interests in pre-2003 securitization in 2006 as it had before and that the failure to update those assumptions as frequently in 2006 as had been the case in earlier years was a mistake.

However, the Examiner did not find any evidence that this change in practice was intentional or designed to affect the overall value of New Century's residual interests. To the contrary, it appears that this change in practice was a mistake, perhaps as a result of poor communications or misunderstanding when overall responsibility for the residual interest valuation models shifted from Mullins to Hatch.[457]

The failure to continue to update those assumptions did not appear to have a significant impact on New Century's residual interest valuations. Furthermore, the documents that troubled the SIC investigators may be important to an understanding of other issues related to New Century's valuation of its residual interests (*e.g.*, New Century's insistence upon using unduly low discount rates, its undue reliance upon the par value assumption, and its decisions to postpone the collapse of older securitizations), but they seem to have little relevance to whether New Century updated the CPR and loan loss assumptions in the models for its pre-2003 securitizations.

[457] No one from New Century seems to have supported KPMG's claim that cost considerations influenced the decision to stop updating these assumptions. To the contrary, Cloyd claims never to have heard cost raised as an issue. Furthermore, the Examiner is not aware of any significant direct costs associated with the process of updating these assumptions, other than an incremental amount of additional time spent by employees who were "rolling forward" the relevant models on a quarterly basis throughout 2006.

C. Other Accounting Issues

The Examiner's investigation analyzed several accounting issues in addition to the repurchase reserve and residual interest valuation issues identified by the Company and discussed above. These issues were reviewed for a number of reasons, including concerns expressed by the SIC, Taj Bindra and others during the spring of 2007 that there might be other areas of New Century's accounting where improper judgments and assumptions may have distorted New Century's financial statements. In addition, workpapers from KPMG's incomplete 2006 audit revealed angst about areas of New Century's accounting that KPMG had not previously questioned, at least not with the same level of detail or intensity.

As a result, the Examiner focused attention on several accounting issues that required important judgments by New Century's Management or were identified as areas of concern in KPMG's workpapers. They included:

1. New Century's deferral and amortization of loan origination fees and costs;
2. The manner in which New Century accounted for mortgage servicing rights;
3. The $77 million in goodwill that New Century recorded in connection with its acquisition of the loan origination platform of the prime mortgage retail division of RBC Mortgage;
4. New Century's allowance for loan losses with respect to loans it held in inventory; and
5. New Century's hedge accounting.

The following sections of this Final Report will analyze each of these accounting issues.

In general, the investigation of these accounting issues did not reveal problems of the magnitude of the repurchase reserve and residual interest issues discussed previously. Nevertheless, these accounting issues did share some disturbing themes with each other and with New Century's accounting for repurchase reserves and residual interests.

First, New Century's Accounting Department repeatedly engaged in accounting practices or methodologies that were inconsistent with GAAP or were otherwise subject to criticism by KPMG. For example, the Accounting Department often resorted to "straight-line" amortization (*e.g.*, with regard to deferred loan original costs and mortgage servicing rights) when accounting standards required more sophisticated methodologies. In addition, the Accounting Department frequently relied upon cash flow models to develop "fair values" of assets rather than make reasonable efforts to obtain market quotations, as KPMG specialists often recommended.

Second, key assumptions underlying New Century's accounting (*e.g.*, with regard to residual interest valuation, mortgage servicing rights and goodwill impairment) were often undocumented or documented in a cursory manner and KPMG's engagement team frequently failed to question or test those assumptions in a rigorous manner.

Third, New Century used discount rates in certain key areas of accounting (*e.g.*, with regard to residual interest valuation and goodwill impairment testing) that seemed unreasonably low when compared to discount rates used by New Century's peer firms or the discount rate that New Century's financial management used internally when developing business plans. This resulted in higher "fair value" estimates than appropriate.

Fourth, KPMG's engagement team seemed unduly willing to acquiesce in New Century's departures from prescribed accounting methodologies and often seemed to resist or ignore suggestions from specialists within KPMG that New Century improve its accounting practices or do a better job of explaining its departures from prescribed accounting practices. At times, it appeared that senior people on the KPMG engagement team became advocates for or defenders of New Century's accounting practices when those practices were questioned by KPMG specialists who had greater knowledge of relevant accounting guidelines and industry practice.

Finally, both New Century's Accounting Department and the KPMG engagement team frequently dismissed or minimized the significance of New Century's accounting errors or New Century's departures from prescribed accounting practices on grounds that they were "immaterial," although the documentation for these conclusions of "immateriality" were often thin or non-existent. Of at least equal concern is that on more than one occasion, when KPMG discovered a problem with a New Century accounting practice and determined that it had resulted in an "immaterial" impact during a particular accounting period, neither New Century nor KPMG appeared to expand its analysis to determine whether that same practice had resulted in material impacts during some prior accounting period. As a result, as to many of these accounting issues, the Examiner was not in a position to conclude whether or not some of New Century's accounting errors materially impacted its financial statements during 2005 and 2006.

1. New Century's Allowance for Loan Losses

a. Executive Summary

The Examiner investigated matters related to the Company's ALL, which was one of New Century's critical accounting areas. The ALL represented a reserve by which New Century sought to provide for probable and reasonably estimable losses on loans held for investment by the Company. Because the potential magnitude of such losses was very large, particularly as New Century grew its portfolio of loans held on its balance sheet, the ALL was a regular focus of New Century's Audit Committee and KPMG. Notwithstanding the significance of the ALL, and the attention paid to it by certain Directors and KPMG, the Examiner identified several inadequacies related to New Century's calculation of ALL.

First, New Century failed to document properly the methodology used to calculate its ALL, as required by GAAP. KPMG was aware that this was an issue, having concluded that it was a significant deficiency in 2004. Furthermore, KPMG discussed proper documentation with New Century and evidently concluded that the deficiency had been remediated in 2005, despite no apparent change in New Century's methodology or documentation policies. The issue persisted and, as part of its audit work for 2006, KPMG utilized a credit specialist who observed continued deficiencies in the Company's documentation of its methodology for calculating the ALL.

Second, the Examiner obtained information that the New Century models used to calculate its ALL were not regularly updated to reflect trends associated with the actual performance of the Company's loan portfolio. Moreover, the Company did not update or modify its models to reflect its then-current assumptions regarding future loan losses. As a result, the models produced ALL figures that deviated substantially from New Century's actual loan loss experience. Neither New Century accounting personnel nor KPMG took steps to cause these models to be updated consistent with the Company's actual loan loss performance or anticipated future losses. This was true even as market conditions began to change dramatically during 2006.

Third, the Examiner determined that New Century overreserved for loan losses throughout the relevant period. Such over-reserving, under circumstances where the Company's methodology is insufficiently documented and its calculations cannot be adequately verified, reflects a significant deficiency in relevant controls. Furthermore, this over-reserving of the

ALL led at least one independent Director to question whether New Century's Management planned to utilize the excess reserves to manipulate earnings.

b. Background Regarding New Century's ALL

i. Relevant accounting principles and guidance

New Century's ALL was governed by the following accounting principles and guidance.

- FAS 5 states that an estimated loss from a loss contingency, such as an uncollected receivable, should be accrued when, based on information available prior to the issuance of the financial statements, it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonably estimated.
- SEC Staff Accounting Bulletin No. 102 *Selected Loan Loss Allowance Methodology and Documentation Issues* ("SAB 102") requires that a company document the development and consistent application of a systematic methodology for determining allowances for loan losses in accordance with GAAP. SAB 102 describes the following documentation the SEC normally expects to be prepared and maintained in support of the allowance for loan losses: (1) written policies and procedures to document the systems and controls by which a company maintains an appropriate loan loss allowance, including the loan loss allowance calculation methodology; (2) a loan grading system or process; (3) a summary or consolidation of the loan loss allowance balance; (4) validation of the loan loss allowance methodology; and (5) periodic adjustment to the loan loss allowance process.[458]
- Financial Reporting Release No. 28 ("FRR 28") provides that the books and records of a company engaged in lending activities should include documentation of: (a) a systematic methodology to be employed each period in determining the amount of loan losses to be reported; and (b) the rationale supporting each period's determination that the amounts reported are adequate.

ii. The Company's calculation of the ALL

New Century established its ALL based on its estimate of losses with respect to on-balance sheet loans held for investment and related assets. The Company determined its ALL on a monthly basis, as it believed that such a methodology more closely mirrored portfolio activity

[458] The SEC has also stated that a company's policies and procedures should identify the roles and responsibilities of company personnel and should include the methodology for estimating loan losses and for charge-offs and recoveries. Further, the SEC has directed that in modeling estimated future losses, companies should document their evaluation and their conclusions regarding the appropriateness of estimating loan losses with model or other loss estimation tools, as well as the objective support for adjustments to the models or their results. When a company identifies particular segments of its loan portfolio for which it is probable that there will be loan losses, the company must document its analysis for an adjustment and include supporting documentation, such as economic reports, economic data and information from individual borrowers. Finally, the SEC has stated that a company should have documented adequate internal controls for ensuring the reliability and integrity of the loan loss estimation methodology.

versus a "life of loan" methodology. The Company's ALL calculation was a rolling 18-month projection based on certain loss rates, prepayment rates and interest rate assumptions applied to the unpaid principal balance of the loans held for investment.[459] Once these factors were applied, the Company used the projected losses for the next 18-month period as its ALL.[460]

The Company evaluated the adequacy of the ALL quarterly, giving consideration to factors such as the current performance of the securitized loan portfolio, credit characteristics of the portfolio, the underlying value of the collateral and the general economic environment. With respect to loans held for investment, the Company estimated losses using "static pooling," which stratified the subject loans into separately identified pools. Such "pooling" and related estimates were performed by Secondary Marketing Department personnel, including Yun Pyatigorsky, John Hatch and Warren Licata, in coordination with Kenneally in Accounting. Using historical experience and taking into consideration the factors noted above, the Company estimated an allowance for losses inherent and probable in the loans held for investment ("LHFI") portfolio. Provisions for losses were charged to the consolidated statement of operations. Actual losses incurred on securitized loans held for investment were charged to the allowance account.

For 2004 through 2006, the Company's ALL balance, provision for losses and loss charge-offs, and the loans held for investment balances, are summarized as follows:

Period	Net LHFI Per SEC Filings	LHFI + ALL	Financing on LHFI	NET	ALL-Begin	Provision	Actual Charge-off	Other Adjust-ments	ALL-End	ALL as % of LHFI + ALL
3/31/2004	5,999.3	6,045.1	(5,991.7)	53.4	26.3	19.9	(0.4)	-	45.8	0.8%
6/30/2004	9,146.5	9,209.1	(9,086.9)	122.2	45.8	17.1	(0.3)	-	62.6	0.7%
9/30/2004	10,890.5	10,975.2	(10,788.2)	187.0	62.6	25.8	(1.1)	(2.6)	84.7	0.8%
12/31/2004	13,195.3	13,285.5	(13,106.0)	179.5	84.7	7.4	(2.3)	0.4	90.2	0.7%
3/31/2005	15,836.2	15,953.7	(15,692.3)	261.4	90.2	30.3	(3.7)	0.7	117.5	0.7%
6/30/2005	18,483.0	18,628.6	(18,343.5)	285.1	117.5	36.9	(8.9)	0.1	145.6	0.8%
9/30/2005	18,330.3	18,508.1	(18,226.8)	281.3	145.6	38.6	(10.0)	3.6	177.8	1.0%
12/31/2005	16,143.9	16,342.0	(16,045.5)	296.5	177.8	28.9	(13.6)	5.0	198.1	1.2%
3/31/2006	16,102.9	16,312.7	(15,948.9)	363.8	198.1	27.8	(18.2)	2.1	209.8	1.3%
6/30/2006	15,905.6	16,115.5	(15,794.3)	321.2	209.8	32.3	(27.2)	(5.0)	209.9	1.3%
9/30/2006	14,031.0	14,222.6	(13,858.9)	363.7	209.9	20.7	(25.4)	(13.6)	191.6	1.3%
12/31/2006	12,218.7	12,413.4	(12,152.0)	261.4	191.6	20.7	(30.2)	12.6	194.7	1.6%

[459] Other factors apply but are not material to the ultimate calculation of the loss reserve.

[460] The Company phased up to an 18-month assumption over the first six months of the securitization's life (*i.e,.* the loss assumption for the first month equaled the projected losses for the next 12 months; the second month loss assumption equaled the projected losses for the next 13 months, and so forth until month six when an 18-month loss projection was reached)

iii. Board oversight of the ALL

New Century's Audit Committee regularly discussed the ALL because it was a critical accounting policy and because it involved a high degree of judgment and subjectivity. According to Zona, the Committee reviewed whether changes had been made to the methodology for calculating the allowance and whether KPMG believed the allowance was reasonably stated. The Audit Committee routinely asked the KPMG auditors to address whether the ALL was adequate. On each such occasion, KPMG personnel expressed the view that the Company's ALL was "reasonably stated" and that "KPMG had not discovered any material differences" related to the Company's estimates.

As discussed more fully below, in late 2005, Zona raised questions with respect to whether the Company contemplated an improper reduction in the ALL – *i.e.*, a "bleeding down" of the reserve – to enable New Century to meet its quarterly earnings target. Zona told the Examiner that he caused the Audit Committee to resist Management's recommendation for a reduction in the allowance at that time.

Later, in 2006, Zona and Einhorn focused on the adequacy of the ALL reserve and questioned whether the 18-month evaluation window used by New Century was adequate. Zona and Einhorn believed the Company may have been under-estimating future losses that would be incurred by New Century as the subject loans aged. With respect to the 2006 audit, the Audit Committee asked KPMG to focus on the ALL. KPMG responded by adding a member of its Consumer Credit Financial Risk Management practice ("FRM") to assist the engagement team on this subject.

c. New Century's Methodology Was Not Properly or Sufficiently Documented

As noted above, the relevant SEC guidance and accounting literature directed New Century to document properly its methodology for calculating the ALL. Notwithstanding this regulatory guidance and related internal controls requirements, the Examiner has determined that New Century failed to document adequately its methodology for calculating the ALL.

KPMG noted that New Century failed to document its ALL methodology and related rationale in connection with its 2004 audit. In particular, KPMG found that there was inadequate documentation evidencing methodology and rationale and no supporting data for the loss curves used by New Century in calculating the ALL. According to a KPMG report to the Audit

Committee, the issue was remediated by New Century as of the end of 2004. The Examiner, however, has been unable to confirm the type and nature of any such remediation.

Later, in connection with its audit work for 2006, KPMG again observed that New Century lacked formal policies and procedures respecting the ALL, that there was insufficient documentation of the ALL base curve, and that there was no evidence the Company timely reviewed related gain/loss worksheets. KPMG concluded preliminarily that the lack of documentation was a material weakness. KPMG also determined that review by a specialist was necessary because KPMG could not rely upon the Company's figures. Accordingly, KPMG enlisted the assistance of a FRM specialist to assist the engagement team. He determined that New Century did not document properly its methodology for calculating the allowance[461] and that the Company failed to use industry best practices in its development and modification of loan loss curves.[462]

d. KPMG Failed to Press New Century to Document Properly Its Methodology

Although KPMG did not identify documentation deficiencies during its 2005 audit, New Century's methodology and documentation for the ALL did not change from 2004 to 2005. Accordingly, the Examiner concludes that the deficiencies KPMG identified in 2004 and 2006 also existed in 2005, but were not identified by KPMG at that time. It also appears that the same documentation deficiency that was allegedly remediated by New Century in 2004 was in fact not remediated in 2004, 2005 or 2006.

KPMG did not press New Century to improve its ALL documentation until the 2006 audit. Given that the substantive guidance provided by SAB 102 focuses predominantly on the documentation of the Company's calculation methodology, the Examiner concludes that additional efforts should have been made by KPMG in a much more timely manner to ensure

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[461] Although New Century's methodology and documentation did not change from period to period, the record of KPMG's reviews did not indicate consistent deficiencies identified for the same processes. The documentation issue appeared in 2004 and 2006, but not in 2005. In addition, the inherent risk for ALL was determined by KPMG to be significant in 2006 but only moderate in 2005. The only apparent change from 2005 to 2006 was the involvement of the credit specialist. This is further indication that KPMG did not devote sufficient resources on a consistent basis to the New Century engagement.

[462] The specialist's KPMG colleagues may not have agreed with his observations. Kim told the Examiner that the specialist was incorrect about the documentation issue, although he could not identify the relevant documentation prepared or maintained by New Century. Further, Donovan told the Examiner that Kenneally rejected the factual basis for specialist's memorandum. However, the Examiner found no evidence that New Century complied with the documentation requirements of SAB 102.

that New Century's calculation methodology was appropriately documented. When asked about these matters, Kim and Donovan told the Examiner that they thought New Century had complied with the requirements of SAB 102, although Donovan said that KPMG did not receive the documentation. Under the circumstances, the Examiner questions the basis for KPMG's regular assurances to the Audit Committee regarding the allowance for loan losses.

e. New Century's Modeling Varied Substantially from Actual Performance and Models Were Not Updated

KPMG's audit workpapers indicate that the Company's actual losses on loans held for investment were significantly different than the Company's modeled losses. New Century's explanation, as documented in KPMG's workpapers, was that it expected its future losses to exceed those reflected by the models used for the 18-month rolling forecast. Stated differently, New Century apparently maintained a "cushion" in its ALL that was designed to address future losses that were expected but were not yet "probable and estimable" under its methodology.

The disconnect between New Century's ALL and both its actual and its anticipated loan losses was well-known within New Century. Nonetheless, the Company's Management balked at suggestions to change the base curves. According to Matthew Mullins, a former senior analyst in the Secondary Marketing Department, Management did not want to lower constant prepayment rates ("CPR") because it would affect the loss reserves. The Examiner found no evidence that Dodge, Kenneally or other internal accountants ever asked for a change in the models, even though it was apparent that the models were poor predictors of actual loan losses.

f. New Century Over-Reserved for Loan Losses

KPMG documented New Century's belief that its ALL was larger than required. KPMG's workpapers state the following with respect to the Company's allowance for loan losses from 2004 through 2006: "The Company believes that the model reasonably supports the above balance as expected losses for some of its earlier models have been lower than initially modeled and thus the allowance has not been reduced by expected charge-offs. The Company believes that the actual losses may exceed modeled in future periods and does not believe it appropriate to reduce the allowance in the current quarter due to what could possibly be timing differences or a period of unusual actual losses." The Examiner found no evidence that KPMG or the Company ever quantified the over-reserve or challenged the appropriateness of the models' assumptions.

New Century's large loss reserve raised potential issues. In late 2005, Zona contemplated resigning from the Board, because, among other reasons, according to him, Management suggested using a portion of the loss reserve to boost quarterly earnings. In October 2005, Zona said that Management tried to adjust its loan loss reserves in order to achieve a certain level of earnings. As Zona reported to the Examiner, New Century experienced a tax problem that reduced earnings by $0.26/per share. Dodge presented a report to the Board of Directors showing that earnings would not be reduced because, as Management argued, New Century was overreserved in its ALL by that exact same $0.26 per share. Zona told the Examiner he was particularly frustrated by what he viewed as Management's lack of integrity, the quality of its financial reporting and New Century's business strategy. Zona added that he made clear he would not approve the financial reports if the adjustment to the loan loss reserve was made.[463] Management did not make the adjustment. As stated in his draft resignation letters, dated November 1, 2005 and December 6, 2005, Zona thought Management's suggestion that the reserve should be reduced to permit New Century to meet its earnings target "smacked of earnings manipulation."

g. Examiner's Conclusion Regarding New Century's ALL

The ALL involved large dollar amounts and substantial risk. GAAP required New Century to document appropriately its methodology for calculating the allowance and to adopt models that it reasonably believed would generate good faith estimates. The Examiner has determined that New Century failed to document properly its methodology for calculating the ALL and that the Company failed to employ appropriate models. The Examiner has also determined that KPMG allowed New Century to utilize poor documentation policies and improper modeling methodology without testing the significance of the variances.

2. New Century's Accounting for Mortgage Servicing Rights

a. Executive Summary

New Century made at least two errors when accounting for its interests in MSRs and made misleading disclosures about how it accounted for MSRs. In addition, KPMG's

[463] Zona described Management's argument for reducing the loan loss reserves and his opposing argument in his November 1, 2005 draft resignation letter as follows: "Management attempted to justify the reversal of loan loss reserves by stating that the delinquency and charge off experience for the portfolio was much better than expected. However, Management also knew that there would be losses from hurricanes Katrina, Rita and Wilma, but had not quantified the amount of the losses. (Wells Fargo and B of A have provided $100 million and $50 million, respectively, for hurricane losses)."

engagement team failed to pursue issues raised by specialists within KPMG who had concerns about New Century's accounting for MSRs.

New Century did not initially record MSRs based on their relative fair values at the time of sale as required by GAAP. Instead, the Company relied on internal estimates of market value that were based on "recent whole loan sale activity and market color." Although KPMG's SFG recommended that New Century obtain at least one independent third-party valuation to validate its internal estimates, it does not appear that the KPMG engagement team ever pushed New Century to do so. In addition, New Century amortized its MSRs on an essentially straight-line basis and failed to apply proportionate method of amortization as required under FAS 140. The Examiner is not in a position to conclude whether these errors in New Century's accounting for its MSRs may have materially affected any of New Century's financial statements.

New Century also made inaccurate disclosures in its financial statements about its initial computation of the fair value of its MSRs, its amortization methodology and its impairment review. These disclosures were inconsistent with the Company's accounting policies and suggest that the Company was in compliance with GAAP, when in fact the Company and the KPMG engagement team knew that it was not.

Finally, it appears that the KPMG engagement team did not actively pursue issues that were raised by specialists within KPMG about the Company's accounting for MSRs. KPMG was quick to excuse the Company's failure to comply with GAAP on grounds that the Company's improper accounting for MSRs was probably immaterial.

b. Mortgage Servicing Rights – In General

The contractual rights to service mortgages after loan origination are called "mortgage servicing rights." Essentially, mortgage servicing includes collecting principal, interest and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets.[464] MSRs become distinct assets or liabilities only when an event occurs that would require the rights to be bifurcated from the underlying loans, such as a sale or

[464] FAS 140 ¶ 61.

securitization.[465] Lenders may service the loan themselves or engage another company to perform the servicing for a fee.

c. Accounting Treatment for Mortgage Servicing Rights – in General

MSRs may be classified as servicing assets or servicing liabilities. If the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, the contract results in a servicing asset.[466] If the benefits of servicing are not expected to be adequate compensation to a servicer for performing the servicing, the contract results in a servicing liability.[467] Typically, a contract results in a servicing asset. The benefits of servicing include revenues from contractually specified servicing fees, late charges and other ancillary sources. The servicer incurs the costs of servicing the asset.

The value of the servicing asset changes over time based on market factors and estimates of future servicing revenue. A seller of loans that retains service rights must allocate value to the servicing asset at the date of sale or securitization. Subsequently, the servicer must adjust the value downward if, based on a change in market factors and estimates of future servicing revenue, the value of the servicing asset falls below the value at which the company carries the asset.

d. The Reported Values of New Century's Mortgage Servicing Rights

New Century retained MSRs on whole loan sales, primarily to Carrington Capital Management, and on loan securitizations accounted for as sales in accordance with FAS 140. The Company generally received fees for servicing these loans.[468] For the year ended December 31, 2005, the Company valued the right to service loans in the range of 65 to 71 basis points of the principal balance sold at the time of sale or securitization, which value represented the Company's best estimate of the fair value for new MSRs.[469]

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[465] FAS 140 ¶ 61.

[466] FAS 140 ¶ 62. Adequate compensation is defined as the "amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace." FAS 140 ¶ 364 (Glossary).

[467] FAS 140 ¶ 62.

[468] Forms 10-K for 2004 and 2005. By contract, the Company received fees of approximately 0.50% of the outstanding principal balance of each loan in the mortgage service portfolio.

[469] The fair market value of MSRs is ordinarily the present value of estimated future cash flows, taking into consideration, among other things, expected prepayment assumptions and discount rates.

New Century reported the following mortgage servicing assets for 2004, 2005 and the first three quarters of 2006:[470]

($in 000's)	2004	2005	Q1 2006	Q2 2006	Q3 2006
Beginning balance	$1,900	$8,249	$69,315	$40,559	$42,096
Additions	7,923	95,120	0	6,796	23,230
Sales of servicing rights	0	(24,877)	(24,516)	0	0
Amortization	(1,574)	(9,177)	(4,240)	(5,259)	(5,448)
Ending balance	$8,249	$69,315	$40,559	$42,096	$59,878

The Company reported the following net servicing income for 2004, 2005 and the first three quarters of 2006:[471]

($in 000's)	2004	2005	Q1 2006	Q2 2006	Q3 2006
Net Servicing Income	$28,896	$38,514	$15,642	$14,012	$17,770

e. Accounting Principles that Governed New Century's Mortgage Servicing Rights

The accounting standard that applies to MSRs is FAS 140.[472] FAS 140 states that, upon the completion of any transfer of financial assets (including securitized loans), the transferor should continue to carry on its balance sheet any retained interests in the transferred assets, including, if applicable, servicing assets or liabilities. FAS 140 requires that the retained interests be measured by allocating the previous carrying amount of the loans transferred between the assets sold and the retained interests based on their relative fair values at the date of the transfer. This means that the company must determine the fair value of the loans (with servicing attached and other retained interests) and must allocate a portion of the cost to the servicing rights retained and other retained interests based on the percentage of total fair value for each component.

i. Determining fair value

The fair value of an asset or liability is the amount at which the asset or liability could be bought or sold in a current transaction between willing parties.[473] According to FAS 140, the best, and preferred, way to measure the fair value of the asset or liability is through quoted

[470] Forms 10-K for 2004 and 2005 and Forms 10-Q for the first three quarters of 2006.

[471] *Id.*

[472] FAS 140 was amended by FAS 156, *Accounting for Servicing of Financial Assets*, in March 2006; however, FAS 156 did not go into effect until the first fiscal year after September 15, 2006 and therefore did not alter New Century's accounting obligations under FAS 140.

[473] FAS 140, ¶ 68. This assumes that the seller is not selling in a forced or liquidation sale.

market prices in active markets.[474] If quoted market prices are not available, the company must estimate fair value by considering prices for similar assets and liabilities and the results of valuation techniques to the extent available.[475] Valuation techniques include the present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models and fundamental analysis.[476] In utilizing valuation techniques, the company should incorporate proper assumptions about interest rates, default rates, prepayment rates and volatility.[477] The estimates must be based on reasonable and supportable assumptions and projections.[478] If it is not practicable to estimate the fair value of assets, the company must list the assets as having zero value.[479]

ii. Allocating carrying amount

Under FAS 140, a company must allocate the amount received in the sale between the loans sold and the retained interests, including MSR, to arrive at the relative fair value basis of each component. For example,[480] a company originates $1,000 of loans that yield 10% interest income for their estimated lives of nine years.[481] The company sells the $1,000 principal plus the right to receive interest income of 8 percent for a total sale price of $1,000. The selling company will continue to service the loans and will receive the right to the portion of the interest income not sold as compensation. The remaining half of the interest income not sold is called an interest-only strip receivable.[482] At the date of the transfer, the fair value of the loans, including servicing, was $1,100. The fair value of the servicing assets was $40. Therefore, the fair value of the interest-only strip receivable was $60. Taking the fair value of the loan with servicing as $1,100, the $1,000 received in the sale for the loans represents 91% of the total fair value. The

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[474] FAS 140, ¶ 68.

[475] FAS 140, ¶ 69.

[476] FAS 140, ¶ 69.

[477] FAS 140, ¶ 69. Applying the present value approach depends heavily on assumptions about default and prepayment of all the assets securitized. FAS 140, Footnote 21.

[478] FAS 140, ¶ 70.

[479] New Century recorded its MSRs as assets. Liabilities are not recorded as having zero value and must be recorded according to the instructions in FAS 140, ¶ 71.

[480] For purposes of this example, the MSRs are servicing assets.

[481] FAS 140, ¶ 65.

[482] The right to future interest income that exceeds contractually specified servicing fees is not a servicing asset and must therefore be accounted for as a separate financial asset. FAS 140, ¶ 63(e).

$40-value for the servicing assets represents 3.6% of the total fair value. When the company allocates the cost between the loans and the retained interests, the loans sold have a carrying amount of $910, the servicing assets have a carrying amount of $36, and the interest-only strip is carried at $54.[483] If the company acquires the servicing rights in a separate transaction, the fair value of the servicing asset is presumably the price paid.[484]

iii. Amortizing the amount recognized

After initially allocating the carrying amount based on relative fair values, the company must monitor the fair value of the servicing assets or liabilities. FAS 140 requires that servicing assets and liabilities be amortized to income or expense in proportion to and over the estimated period of time in which the company earns net servicing income (if servicing revenues exceed servicing costs) or incurs net servicing losses (if servicing costs exceed servicing revenues).[485] In the example given above, the company would amortize $36 over the nine-year period in which it expected to service the loans. The amortization of the cost basis of MSRs should reflect actual prepayment experience. Amortization speeds should correspond, and be adjusted to reflect changes in the estimated remaining net servicing income period.

iv. Assessing impairment

FAS 140 also requires that a company assess servicing assets and liabilities for impairment (or increased obligation) based on their current fair values.[486] This is a multi-step process. First, the company must stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. These characteristics include financial asset type (conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans), size, interest rate, date of origination, term and geographic location.[487] Second, the company must recognize impairment equal to the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. For example, if the quoted market price is below the amount at which the company currently measures the servicing asset's value, the company must decrease the servicing asset's value to

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[483] The calculations are as follows: $1,000 X 91% = $910; $1,000 X 3.6% = $36; and $1,000 X 5.4% = $54.

[484] FAS 140, ¶ 13

[485] FAS 140, ¶ 13.

[486] FAS 140, ¶ 13.

[487] FAS 140, ¶ 63(g). *See also* FAS 140, Footnote 19.

the quoted market price and recognize the difference as impairment in its financial statements. Third, the company must adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement.[488]

v. Disclosures

A company must disclose certain information about its accounting for MSRs. In each accounting period, the company must disclose the amounts of servicing assets or liabilities recognized and amortized; the fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate that fair value; the risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment; and the activity in any valuation allowance for impairment of recognized servicing assets.[489] The company must also disclose its accounting policies for initially measuring retained interests, including the methodology it used in determining fair value. The disclosures should include a list of the key assumptions used in measuring fair value of retained interests at the time of securitization.[490] In addition, the company must disclose its accounting policies for subsequently measuring those retained interests, including the methodology and key assumptions used in determining their fair value, as discussed above.[491]

f. New Century's Accounting for Its Mortgage Servicing Rights

i. In general

New Century did not have formal accounting policies and procedures regarding its accounting and disclosure of MSRs. However, information regarding the Company's approach to these issues is contained in a memorandum that Kenneally wrote dated February 2007 (the "Kenneally Memorandum"), as well as in KPMG's year-end 2005 workpapers. New Century's methodology appears to have been consistent from 2005 to 2006.

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[488] FAS 140, ¶ 63(g)(3).

[489] FAS 140 ¶ 17(e).

[490] FAS 140 ¶ 17(f). FASB requires, at a minimum, that the company include quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses.

[491] FAS 140 ¶ 17(g).

g. Specific Issues

i. Fair value calculations

New Century initially valued its MSRs using internal values rather than an allocation of the loans' carrying amounts. According to the Kenneally Memorandum, New Century chose not to use the fair value measurement method.[492] Instead, Management derived fair value based on "recent whole loan sale activity and market color." New Century stratified the MSRs by deal because "the Company's core collateral pools consist of homogeneous non-prime originations, which generally evolve with the market environment." New Century did not obtain third-party valuations for its MSRs because it believed that its approach was reasonable based on the overall materiality of its mortgage servicing assets.

ii. Amortization

New Century amortized its servicing portfolio using a constant amortization rate rather than a proportionate method. The Kenneally Memorandum stated that New Century used cash flow models in its amortization computations. The Secondary Marketing Department updated the models to reflect the unpaid balance and assumptions for prepayments, credit losses and interest rates. The Company then computed a constant amortization rate so that the remaining cost basis was amortized over the remaining life of the deal by the Accounting Department. New Century chose this methodology because it "appears to closely approximate the expected cash flows of the transactions underlying" the MSRs.

iii. Impairment

New Century did not believe that it needed to establish an impairment allowance for its MSRs because Kenneally thought that the outstanding cost basis for these rights was a reasonable estimate of their fair value.

iv. Disclosures

New Century stated in its public disclosures that it valued MSRs using relative fair values at the time of sale. The Company stated that it amortized by a proportionate method, as required by FAS 140. In addition, New Century stated that it reviewed and assessed potential impairment of its MSRs. In its Form 10-K for 2005, New Century stated:

> Mortgage servicing rights ("MSRs") retained in the sale of mortgage loans are based on relative fair values at the time of sale. The MSRs are carried at the

[492] Kenneally referred to FAS 156 as if it were in effect for 2006. FAS 156 did not apply until the following fiscal year.

> lower of cost or fair value. Fair values of MSRs are determined based on the present value of estimated future cash flows related to serviced loans. Assumptions used in estimating the value of MSRs include market discount rates and anticipated prepayment speeds including defaults, estimated ancillary fee income and other economic factors. The prepayment speeds are estimated using the Company's historical experience and third-party sources. The MSRs are amortized to earnings in proportion to, and over the period of, estimated net future servicing revenue. The Company used an estimated market discount rate of approximately 18% which it believes is representative of the rate equal to the return that would adequately compensate a substitute servicer for performing the servicing.
>
> MSRs are reviewed quarterly for potential impairment. Impairment is assessed based on fair value. MSRs are stratified by: the fiscal year of the loan sale date and loan type. When MSRs are reviewed, management makes an estimate of the future prepayment rates and other key variables of the underlying mortgage loans. If actual prepayment rates prove to be higher than the estimate, impairment of the MSRs could occur.[493]

This disclosure was inaccurate in several respects. First, it did not accurately describe the manner in which New Century valued servicing assets at the time of sale. Second, it claimed that New Century used a proportionate method as required by FAS 140 to amortize those rights, when in fact the Company used a constant amortization method. Third, it stated that New Century reviewed its servicing portfolio for potential impairment when, in fact, it did not.

The inaccuracies in this disclosure are particularly surprising because both the Audit Committee and the Disclosure Committee reviewed the Company's disclosures with regard to mortgage servicing and purportedly received reports from KPMG about its review and audit of New Century's accounting for MSRs.

h. KPMG's Role with Regard to New Century's Mortgage Servicing Rights

Kim could not recall whether New Century had a formal accounting policy for MSRs. According to Kim, New Century's MSRs represented a small portion of its entire balance sheet so that valuation of MSRs was not significant to him, although KPMG reviewed the valuation of MSRs on a quarterly basis and audited the valuation of MSRs at December 31, 2005.

KPMG's workpapers acknowledged that New Century recognized MSRs based on fair value, as determined by the Secondary Marketing Department, rather than on the basis of an allocation of carrying amount as required by FAS 140. The workpapers noted that this

[493] Form 10-K for 2005, Notes to Consolidated Financial Statements, 1(r), pp. F-17 to F-18.

methodology did not comply with GAAP. Kim could not recall how the Secondary Marketing Department determined the fair value of New Century's MSRs, but acknowledged that the proper determination of carrying value under FAS 140 was not laborious. A handwritten note on KPMG's substantive testwork memorandum states that New Century performed that calculation to determine the difference between the company's method and the FAS 140 method. For 2005, KPMG determined that the difference was $698,217, which was below the income statement posting threshold of $923,000.

KPMG reviewed New Century's valuations by comparing the servicing values for New Century's MSRs to those of New Century's competitors. KPMG determined that the basis points and multiples used in the valuation methodology were reasonable and within the range of values reported by comparable companies, but noted that New Century should perform a formal valuation because there could be an audit difference.

KPMG was aware that New Century's valuation methodology carried an inherent risk of inaccuracy. SFG recommended in February 2006 that New Century obtain at least one independent third-party valuation to validate its internal valuation. Kim thought that third-party valuations were not necessary, but he admitted that Macaulay and one of the specialists recommended them. Macaulay stated an SFG credit specialist who undertook a supplemental review in 2007 identified the valuation of MSRs as an area with a risk of fraud and material misstatement.

i. Amortization

Kim understood that New Century amortized its servicing rights portfolio using a constant amortization rate rather than the required amortization method. According to KPMG's workpapers, New Century amortized MSRs based on electronic amortization tables, which calculate amortization based on the estimated remaining life of the relevant loan pools. New Century used residual models, which updated the amortization schedule with the current unpaid balances and expected remaining life. KPMG noted that this was the same amortization schedule that the Company used for its FAS 91 calculations.[494]

In a February 26, 2006 memorandum, three members of KPMG's SFG stated that New Century utilized a modified form of straight-line amortization methodology to amortize its servicing rights portfolio, which was not the same method as the net proportionate method

[494] FAS 91 governs the amortization of loan origination fees and costs.

outlined in FAS 140 and did not accurately reflect the market value and economics of the servicing assets. KPMG also recommended that New Century perform a formal valuation of the servicing assets at least quarterly.

i. Examiner's Conclusions Regarding New Century's Mortgage Servicing Rights

The Examiner has concluded that New Century improperly recorded the initial carrying amounts of its mortgage servicing assets. Under GAAP, the Company was required to record their initial amounts by allocating the carrying amount of the relevant loans (with servicing) between the loans sold and the interests retained, including servicing rights. KPMG identified this variance as an issue, but only quantified the difference for 2005, when, KPMG determined, the difference was below its posting threshold. The Examiner is unable to determine whether there would be an audit difference for 2006 but notes that New Century did not change its methodology after KPMG's SFG recommended a change in February 2006. There is no indication that KPMG's engagement team urged New Century to change in its methodology in the first three quarters of 2006.

The Examiner has also concluded that New Century did not apply a proportionate method of amortization as required under FAS 140, but instead used a constant amortization rate (similar to a straight-line method) to amortize the servicing portfolio. Using a proportionate method would have yielded higher amortization during periods when the estimated income or loss was expected to be greater and lower amortization during periods when the estimated income or loss was expected to be less. Although the amortization resulting from each method would be the same over the total life of the MSRs, the difference between the two methods could be material from period to period. The Examiner did not have sufficient information to measure the potential impact of New Century's use of an improper amortization method.

The Examiner has further concluded that New Century inaccurately disclosed its initial carrying amount computation and amortization methodology for MSRs in its public filings. Information learned during the investigation suggests that these inaccuracies were not inadvertent, because New Century's Accounting Department and KPMG were aware that New Century's accounting practices for MSRs were different than those described in its public disclosures.

3. New Century's Deferral and Amortization of Loan Fees and Costs

a. Executive Summary

New Century made at least two errors over a period of years when accounting for the fees it received and the costs it incurred in originating mortgage loans. Although KPMG dismissed one of these errors as immaterial in 2006, neither the Company nor KPMG adequately addressed the materiality of these errors with respect to prior financial statements that may have been affected.

First, New Century used an improper methodology to amortize deferred loan origination fees and costs that, according to KPMG, was inconsistent with FAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* ("FAS 91"). Although KPMG preliminarily concluded that this violation of GAAP was not material for purposes of New Century's 2006 financial statements, neither New Century nor KPMG ever addressed the likely impact of this error on New Century's earlier financial statements.

Second, beginning in 2004, New Century improperly excluded certain costs from its deferral and amortization methodology on the basis that those costs were associated with correspondent loans. Although KPMG discovered in the second quarter of 2006 that the loans at issue were not correspondent loans, neither New Century nor KPMG made any effort to determine the likely impact of this error on New Century's earlier financial statements.

Because New Century and KPMG did not properly test the significance of the errors in New Century's accounting for loan origination fees and costs, the Examiner cannot determine whether those errors may have had a material impact on New Century's financial statements.

b. New Century's Loan Origination Fees and Costs

New Century funded over $10 billion of loans each quarter between the fourth quarter of 2004 and the fourth quarter of 2006. New Century earned fees and incurred certain costs as part of its business of originating mortgage loans, whether New Century made the loans directly (through its retail division) or purchased them from its network of brokers (through its wholesale division). Net loan origination fees and costs amounted to approximately one percent of the total value of the loans originated. In general, New Century received loan origination fees that were collected from borrowers at closing in the form of points, commitment fees and application fees. New Century incurred direct loan origination costs in the form of payments for credit reports,

appraisals, flood certifications, and document preparation and in the form of compensation for employees directly involved in the loan origination process.

c. Accounting Treatment for Loan Origination Fees and Costs

FAS 91 requires that all non-refundable loan origination fees and the direct costs associated with lending, committing to lend or purchasing a loan or group of loans be deferred and amortized over the life of the underlying loans. FAS 91 requires the holder of a loan, or group of loans, to recognize loan origination fees (net of origination costs) as an adjustment to yield(s) over the life of the loan(s) using an interest rate method that results in a constant effective yield (sometimes known as a "level-yield" calculation).[495] This amortization method accounts for the difference between a loan's stated interest and the actual interest earned by the company in any given accounting period when net origination fees and costs are considered. For example, if a lender collects a $1,000 fee from a borrower and incurs $400 in direct costs, the net $600 fee ($1,000 - $400) must be amortized over the term of the loan by adjusting that loan's effective interest rate.

Only qualified direct loan origination costs may be deferred to another accounting period. Lending-related costs other than qualified direct loan origination costs must be charged to expense in the period they are incurred. FAS 91 requires that management exercise judgment in developing and implementing a methodology for properly identifying and segregating only qualified direct loan origination costs for deferral. Methodologies for identifying qualified direct loan origination costs are subject to various assumptions about the types of costs incurred and their relation to successful loan origination efforts. These assumptions affect the amount of costs that are deferred.

d. The Reported Values of New Century's Deferred Loan Origination Costs

New Century maintained two pools of loans. One pool, loans held for sale, consisted of loans which the Company intended to sell in either whole loan sale transactions or securitizations structured as sales. The other pool, loans held for investment, consisted of loans that were securitized or that the Company intended to securitize in on-balance sheet securitizations. Fees and costs associated with loans held for sale were deferred until the loans were sold. At that

[495] The level-yield method of amortization seeks to create a constant yield over the life of the underlying loan. This means that a different amount of amortization is recorded each period to achieve the constant (or level) yield. The yield is the interest earned on the loan divided by the principal balance of the loan (net of deferred costs).

time, New Century recognized the deferred fees and costs in determining its gain on the sale of the loans. Fees and costs associated with loans held for investment were deferred and amortized over the expected lives of the loans. This means that the Company recognized the fees earned and the costs incurred over a period of time, based on the length of time the Company expected the loans to remain outstanding. On a monthly basis, New Century's Accounting Department recalculated the life expectancy of these loans, based on the actual and estimated rates at which borrowers prepaid the loans.

The chart below reflects the amount of loans New Century held for sale, the amount of loans it held for investment and the associated net deferred loan origination costs for five quarters between 2004 and 2006.

Deferred Costs as a Percentage of Loans Held for Sale and Loans Held for Investment (1)

Quarter	LHFS	Deferred	Percentage	LHFI	Deferred	Percentage
Q4 2004	$3,898,998	$38,673	0.99%	$13,169,596	$122,285	0.93%
Q4 2005	7,815,201	19,960	0.26%	16,184,233	140,996	0.87%
Q1 2006	6,341,566	21,212	0.33%	16,194,665	128,533	0.79%
Q2 2006	9,267,890	35,263	0.38%	16,005,457	119,934	0.75%
Q3 2006	8,907,251	38,011	0.43%	14,131,294	78,273	0.55%

(1) All figures derived from New Century's records

e. New Century's Amortization of Loan Origination Fees and Costs

New Century initially recorded all fees earned and costs incurred in the loan origination process as income and expense items. At the end of each month, New Century performed a calculation, utilizing assumptions based on past experience, to determine what percentage of the loan origination costs it had incurred related to successfully funded loans. This percentage was then applied to the total costs incurred for the period to arrive at the amount to be deferred. New Century further categorized deferred loan fees and costs depending on whether the loans at issue were loans held for sale or loans held for investment.

Walker was responsible for the initial calculation each quarter of the percentage of net origination fees and costs to defer for a specific period of time. Walker did not have the ability to capture direct origination costs on each individual loan. Instead, she pooled the costs, allocated them on a pro rata basis, and multiplied the net costs by the percentage of loan originations that were held for sale at the end of the period to determine the FAS 91 deferral. After Walker determined the initial deferral amount that was to be used in the amortization

calculation for loans held for investment, she gave her computations to Kenneally and his staff, who performed the actual amortization calculations.

It appears that New Century followed the same methodology for calculating amortized fees and costs from the fourth quarter of 2004 through the third quarter of 2006. The Accounting Department calculated a proposed journal entry to record the deferral. The source of the deferral calculation was a monthly trend report. The Examiner was unable to match these monthly trend reports to New Century's general ledger accounts. The Examiner also could not determine whether the trend reports were prepared on a consistent basis from period to period. Although Walker claimed that New Century's methodology for the deferral and amortization of loan origination fees and costs was reviewed for compliance with GAAP, New Century did not properly apply the interest rate method of amortization as prescribed by FAS 91, which results in a level yield, but instead amortized these fees and costs using a formula that resulted in a constant amount of amortization in each period.

Beginning in the third quarter of 2004, New Century began excluding direct loan origination costs that purportedly were incurred in connection with correspondent loans. Correspondent loans are loans that are underwritten, approved and funded by an independent mortgage company. New Century, as the correspondent's sponsor, purchased or funded those loans, generally at a premium. The Company continued to exclude costs purportedly associated with correspondent loans until the second quarter of 2006, when New Century determined that the loans at issue were not correspondent loans, and the fees and costs should have been included in New Century's deferral calculations. There is no evidence that New Century or KPMG assessed the potential impact of this error in 2005 or 2006, and neither New Century nor KPMG offered the Examiner any explanation for this error.[496]

f. KPMG's Role with Regard to New Century's Amortization of Loan Origination Fees and Costs

KPMG determined that New Century was accounting for loan origination fees and costs in accordance with FAS 91 from at least the first quarter of 2004 through the third quarter of 2006. KPMG workpapers related to the Company's accounting for loan origination costs and

[496] According to KPMG workpapers for the third quarter of 2004, Kenneally indicated that the maximum financial impact of excluding commissions paid for correspondent loans that quarter was approximately $1.5 million less accumulated amortization. There is no evidence to suggest that KPMG independently confirmed this potential financial impact.

fees suggest that KPMG performed substantially the same procedures for each of its quarterly reviews and annual audits during this period. The quarterly memoranda remained virtually unchanged from Q4 2004 through Q3 2006. Until then, KPMG considered the inherent risk associated with New Century's accounting of loan origination fees and costs to be "low."

Although New Century's methods of accounting for loan origination fees and costs do not appear to have changed before the end of 2006, KPMG's procedures for auditing those accounting methods did change. For instance, KPMG changed its inherent risk assessment for this area of New Century's accounting from "low" to "moderate" and, for the first time in years, the KPMG memorandum that discussed New Century's accounting for loan origination fees and costs was substantially rewritten. Also, apparently for the first time, KPMG assigned a credit specialist from the SFG to conduct a supplemental review of these issues under the supervision of KPMG's concurring partner. Macaulay, the concurring partner, did not explain why this supplemental review was conducted in connection with the 2006 audit, but assumed it was based on KPMG's increased assessment of risk.

Although he was the senior audit manager, Kim could not explain the reason for the change in risk assessment. KPMG's workpapers suggest it was because New Century was not amortizing deferred origination costs on a loan-level basis "which brings into question the accuracy and adequacy of amortization based on the Company's current portfolio performance." A planning document for the 2006 incomplete audit also raised questions about New Century's practice of amortizing loan origination costs on a portfolio basis rather than on a loan-by-loan basis, suggesting that this methodology was prone to error, even though New Century had been using that same methodology for a number of years. Kim dismissed this criticism in the KPMG planning document on the grounds that it had not received the "appropriate" level of review. Macaulay did not agree with Kim's view.

Whether or not the KPMG engagement team reached any conclusion about the propriety of New Century's practice of amortizing loan origination costs on a portfolio basis, the engagement team apparently reached a consensus about another problem. Although KPMG did not complete its 2006 audit, its workpapers indicate that it had concluded, at least preliminarily, that New Century's accounting for loan origination fees and costs was not in compliance with GAAP. According to KPMG, New Century was not properly applying the interest rate method of amortization required by FAS 91 because New Century was not properly calculating a level-

yield.[497] According to Kim, this error originated in models designed by New Century's Secondary Marketing Department.

KPMG preliminarily determined that an adjustment of $261,060 was needed because of New Century's improper amortization methodology. Although this adjustment was below KPMG's posting threshold, KPMG apparently did not address the impact that New Century's improper amortization methodology may have had on prior accounting periods.

g. Examiner's Conclusions Regarding New Century's Loan Origination Fees and Costs

The Examiner agrees with KPMG's preliminary conclusion that New Century improperly amortized its deferred loan origination fees and costs during 2006 because it did not use the level-yield method required by FAS 91.

Although KPMG concluded that this violation of GAAP did not result in a material error in 2006, neither KPMG nor New Century ever addressed the likely impacts of this error on New Century's financial statements for prior periods in which the error also occurred. The Company and its independent auditors should have considered those impacts, given that both knew that this improper amortization methodology had existed prior to 2006.[498] Because they failed to do so, the Examiner cannot conclude whether New Century's improper amortization methodology had a materially adverse impact on New Century's earlier financial statements.[499]

The Examiner also finds as problematic the way the Company and KPMG dealt with New Century's improper exclusion of certain costs that were purportedly related to correspondent loans from its deferral of loan origination costs. It appears that, in the second quarter of 2004, KPMG did not test Kenneally's representation that the excluded costs were immaterial. Then, during the second quarter of 2006, when KPMG discovered that New Century had improperly classified certain loans as correspondent loans, there is no evidence that New Century or KPMG made any effort to determine the financial impact of that improper classification in prior accounting periods. As a result, the Examiner cannot determine what, if any, impact that improper classification had on New Century's financial statements.

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[497] Kim could not recall whether New Century amortized its loan origination fees and costs on a level-yield basis, but suggested that level-yield amortization is only one of several acceptable amortization methodologies.

[498] KPMG did not test the amortization methodology prior to the 2006 year end audit.

[499] In addition, the Examiner could not determine whether the trend reports New Century used to accumulate costs for the loan origination fee and cost deferral calculation were prepared in an accurate and consistent manner. Irregularities or errors in those trend reports could have led to additional problems that the Examiner cannot assess.

4. New Century's Hedge Accounting Practices

a. Summary of Conclusions

The Examiner identified several deficiencies related to New Century's hedge accounting practices. First, the Company failed to adopt a comprehensive and effective set of policies, procedures and practices relating to hedging until 2006. Its previous hedging policy documentation did not describe all the hedging strategies used by the Company, did not describe the methods used to test for hedging effectiveness, and failed to address other important aspects of its hedge accounting practices. In addition, KPMG identified two significant deficiencies relating to New Century's hedging practices during the 2004 and 2005 SOX audits.

Second, New Century did not document adequately its hedge accounting practices "contemporaneously" with the inception of certain hedge relationships, as required under the relevant financial accounting standards. New Century only provided "draft" documentation to KPMG in the first quarter of 2005 to support the designation of its hedging relationships at inception.

Third, New Century's hedge accounting documentation in 2005 was insufficient because it did not explain how the ineffectiveness portions of changes in the fair value of the derivatives accumulated in other comprehensive income ("OCI") would be reclassified into current earnings. In addition, the Company's hedge documentation did not adequately support its projection of future cash flows from on-balance sheet securitizations because of volatile prepayment speeds. These problems resulted in internal disagreements at KPMG and almost prevented the timely filing of New Century's Form 10-K for 2005.

Fourth, the Company inaccurately disclosed that it accounted for interest rate lock commitments ("IRLC") as derivatives at fair value for all of its loans. In fact, it did so only for prime mortgage loans (and not subprime loans, which accounted for the vast majority of its originations). As a result, New Century failed to recognize the effect of IRLC associated with subprime mortgage loans in its financial statements.

All of the foregoing deficiencies in New Century's hedging practices were identified by KPMG during the course of its SOX and substantive audit work. The deficiencies include poor documentation and other accounting practices by New Century, and the lack of strict compliance with applicable accounting standards in the hedging area. In addition, several of these deficiencies were not resolved when KPMG signed off on New Century's Form 10-K for 2005.

The Examiner has not conducted an analysis of whether any of these deficiencies were material, although the evidence strongly suggests that most of the deficiencies were not material to New Century's financial statements from a purely quantitative standpoint (and, to the extent there were errors requiring adjustment, the impact would have been the release of additional income to New Century). However, New Century did make one audit adjustment in 2006 based on the concerns raised by KPMG about its hedging practices prior to the filing of the Company's Form 10-K for 2005. The implications of this adjustment and the other deficiencies are described more fully below.

b. Hedge Accounting Generally

Many companies use derivative financial instruments to limit their exposure to different risks (*e.g.*, interest rate risks, foreign exchange risks and commodity risks) that could have a negative impact on earnings or cash flows. When these derivative instruments qualify for hedge accounting treatment and this treatment is elected by the Company, their cash flows and changes in value can be used to offset changes in the value of assets and liabilities that are hedged during the periods when those changes occur. When these derivative instruments do not qualify for hedge accounting treatment, such offset is not permitted, and any change in the value of the derivatives goes straight to the company's bottom line (which often leads to earnings volatility). Thus, the goal of hedge accounting is to match periodic changes in the value of the hedging instruments with the underlying hedged risk, thus removing volatility from earnings. As a result, an entity can mitigate the impact of economic risks (such as interest rate movements) on its performance and the attendant profit and loss ("P&L") effect arising from derivatives used for hedging.

Hedge accounting is a complicated accounting concept that involves highly technical and complex rules as well as extensive documentation requirements. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activity* ("FAS 133"), establishes accounting and reporting standards for derivative instruments and hedging activities (including the implementation and continued use of hedge accounting). [500] All derivatives within the scope of FAS 133 must be recorded at "fair value" as an asset or a liability on the company's balance

[500] FAS 133 and related guidance define derivative instruments as not only those instruments that are traditionally considered derivatives (such as swaps, options, and forwards), but also certain other instruments that may be embedded in cash instruments and any other non-derivative contracts.

sheet. The accounting for changes in the fair value of a derivative instrument (*i.e.*, gains and losses) depends on the intended use of the derivative and any resulting hedge designation.

To qualify for FAS 133 hedge accounting, a derivative instrument must be shown to be "highly effective" in correlating to changes in the hedged risk on a retrospective and prospective basis, and the reporting enterprise must have the appropriate hedge documentation in place at the inception of the hedge that establishes such effectiveness. If the derivative instrument does not meet the effectiveness criteria, it would be considered ineffective and all changes in the fair value of the derivative instrument would flow through earnings in the period of the change. Such ineffectiveness can produce significant volatility in corporate earnings.

i. Relevant types of hedge accounting

There are two types of hedge accounting relevant to New Century's activities: (1) cash flow hedging; and (2) fair value hedging. Cash flow hedging is intended to address exposure to the variability in the cash flow of a recognized asset or liability, or of a forecasted transaction. Cash flow hedge accounting requires that the effective portion of the gain or loss from a derivative instrument designated as a cash flow hedge be reported in OCI in the current period. It is subsequently reclassified into earnings when the hedged asset, liability or forecasted transaction affects earnings. The ineffective portion of a cash flow hedge must be reported in current period earnings.

Fair value hedging involves a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, which are attributable to a particular risk. For fair value hedges, this is achieved by marking-to-market an asset or liability which offsets the P&L movement of the derivative. Fair value hedge accounting requires that changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability attributable to the hedged risk be reported in current earnings. The effect of such accounting treatment is to reflect in current earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

For a derivative not designated as a hedging instrument, the gain or loss on the change in fair value is recognized in earnings in the period of change. Where a hedge relationship is effective, most of the mark-to-market derivative volatility will be offset in the P&L account.

ii. Documentation requirements

Proper hedge accounting treatment requires significant attention to compliance requirements. Hedge accounting is an exception to the usual rules for financial instruments. Strict criteria must be met before it can be used. Management must identify, document and test the effectiveness of those transactions for which it wishes to use hedge accounting. For derivative hedging activities to qualify for hedge accounting, the following documentation is required at the inception of *each* hedge:

(1) A description and the specific terms of the hedging relationship and the risk management objective and strategy for undertaking the hedge;[501]
(2) A description of the hedging instrument (the derivative);
(3) A description of the hedged item;
(4) A description of the nature of the risk being hedged;
(5) For fair value hedges, a description of how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value will be assessed;
(6) For a fair value hedge of a firm commitment, a description of a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment;
(7) For cash flow hedges, a description of how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows will be assessed;[502] and
(8) A description of the methodology to be used to measure hedge ineffectiveness.[503]

In addition, retrospective and prospective effectiveness must be tested periodically to demonstrate the hedging relationship continues to be effective.

c. Derivative Instruments Used by New Century

New Century used various derivative instruments as part of its strategy to mitigate interest rate risk associated with its financing on mortgage loans held for sale, mortgage loans held for investment, and residual interests. Such derivative instruments included: Euro Dollar futures; [504] interest rate cap contracts;[505] interest rate swap contracts; non-designated hedge

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[501] The company must prove, both prospectively and retrospectively, that the hedge relationship is effective.

[502] Whether fair value or cash flow hedging is used, FAS 133 guidance requires a reasonable basis for how the company plans to assess the hedging instrument's effectiveness.

[503] The methodology used to test hedge ineffectiveness is subject to guidance issued in EITF Topic No. D-102 and DIG Issue G7. There are three primary methods of testing the hedging ineffectiveness of forwards, futures, and swaps: the dollar-offset method, the variability-reduction method, and the regression method. New Century elected to use the regression method.

[504] Euro Dollar futures may be both cash flow and fair value hedge instruments. New Century had open Euro Dollar futures contracts that were designated as hedging the variability in expected cash flows from the variable-rate debt related to its financing on mortgage loans held for investment. The fair value of these contracts at December 31,

instruments; [506] and free-standing derivatives (interest rate lock and forward sale commitments).[507] These instruments were intended to provide income and cash flow to offset potential reduced interest income and cash flow under certain interest rate environments. Pursuant to FAS 133, these derivatives and any related margin accounts were required to be reported on New Century's balance sheet at fair value.

d. Methodology for Assessing and Measuring Hedge Effectiveness

Under FAS 133, a company that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective portion of the hedge. These testing methods must be consistent with the purpose of the hedge.

A hedge is regarded as effective only if, at inception and during the life of the hedging relationship, the hedge is expected to be highly effective in offsetting changes in the hedged item's fair value or the variability in cash flows attributable to the hedged risk. While there are differing interpretations of "highly effective," FAS 133 requires only that some reasonable measure of effectiveness is used. For example, if the company uses the regression method, as New Century did, paragraph 75 of FAS 133 states that if the price of the hedged item and the price of the hedging derivative are highly correlated, it is reasonable to expect the hedge to be

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2005 and 2004 was $80.9 million and $26.1 million, respectively, and was included in prepaid expenses and other assets. As of December 31, 2005, the Company also had open Euro Dollar futures contracts that were designated as fair value hedges. The fair value of these contracts at December 31, 2005 was $0.9 million and was included in accounts payable and accrued liabilities. The fair value of these contracts was substantially offset by changes in the fair value of the hedged assets.

[505] The fair value of these interest rate cap contracts at December 31, 2005 and 2004 was $0.5 million and $7.4 million, respectively, and was included in prepaid expenses and other assets.

[506] The fair value of these contracts at December 31, 2005 was $0.6 million and was included in prepaid expenses and other assets.

[507] A mortgage company is exposed to interest rate risk from the time the IRLC is made to a residential mortgage applicant until the time that mortgage loan is sold. During this period, the value of the IRLC or mortgage loan may decline as a result of interest rate increases. IRLCs are recorded at fair value with the changes in fair value recognized in current period earnings as part of gain on sale of mortgage loans. To manage this interest rate risk, the Company used primarily forward sales commitments that were recorded at fair value with the changes in fair value recognized in current period earnings as a part of gain on sales of mortgage loans. The aggregate fair value of these free-standing derivatives on the consolidated balance sheet was a net liability of $1.1 million at December 31, 2005, and was included in accounts payable and accrued liabilities.

"highly effective" in offsetting price changes. That is, in order to be highly effective, the gains or losses of derivatives should offset changes in fair values or cash flows of the hedged item.[508]

When a hedge fails the effectiveness test, hedge accounting is discontinued prospectively. Hedges are seldom, if ever, perfectly effective. Any hedge ineffectiveness, even if the hedge continues to be considered effective overall, must be recognized in earnings in the current period. An assessment of effectiveness is required at least every three months.

e. New Century's Hedge Accounting Procedures — Generally

As mentioned above, New Century utilized both cash flow and fair value hedge accounting. New Century accounted for certain Euro Dollar futures contracts and interest rate cap contracts as hedges. In accordance with FAS 133, these contracts were designated from inception as hedging the exposure to variability of cash flows from the Company's financing on mortgage loans held for investment attributable to changes in interest rates. New Century also used Euro Dollar futures contracts and interest rate swaps to hedge the interest rate risk associated with debt issued in conjunction with its on-balance sheet securitizations. In addition, to a lesser extent, certain Euro Dollar futures contracts were designated as hedges of the fair values of certain mortgage loans held for investment and certain mortgage loans held for sale. These fair value hedging activities were not all accounted for using hedge accounting and were generally immaterial to the Company's earnings. In addition, the Company used Euro Dollar futures contracts not designated and documented as hedges to hedge the fair value of its residual interests in securitizations. The Company asserts that it did not use derivative instruments for the purpose of speculating on changes in interest rates.

f. Specific Issues Relating to New Century's Hedge Accounting Treatment

As set forth below, the Examiner has determined there were several instances in which New Century departed from strict compliance with FAS 133 or otherwise lacked inadequate documentation or engaged in and other important hedge accounting practices.[509]

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[508] While the meaning of the term "highly effective" is subject to interpretation under applicable accounting principles, a generally accepted measure of correlation is that the regression of changes in the hedged item to changes in the derivative should have an adjusted R-squared value of at least 80%.

[509] FAS 133 is a very complex, technical accounting standard and there can be legitimate differences of opinion on whether certain practices violate FAS 133. At a minimum, unless otherwise stated, the deficiencies described in this Section of the Final Report were not consistent with best practices and raised serious questions about the adequacy of New Century's internal controls in the hedging area.

i. New Century had significant deficiencies in its hedge accounting policies and procedures

Prior to late-2006, New Century failed to adopt a comprehensive and effective set of polices and procedures relating to its hedge accounting activities. The Company's previous hedging policy document, which was last updated in 2003, failed to describe all of the different hedging strategies used by the Company to manage interest rate risk. In addition, the policy document did not describe with specificity the methods used by New Century to test for hedge effectiveness and ineffectiveness. These and other documentation and control deficiencies with New Century's hedging policies and procedures were identified during the SOX process in 2004 and 2005.[510]

In fact, one of the five significant deficiencies reported by KPMG to New Century's Audit Committee as part of the 2004 audit related to its hedging practices. Specifically, KPMG noted that New had failed to reconcile certain liability accounts related to derivatives and did not have a full understanding of the margin account activity with its investment broker. This resulted in a $30.9 million audit adjustment to reflect the OCI existing upon the termination of a Euro Dollar futures contract in the fourth quarter of 2004.

The only significant deficiency reported to the Audit Committee by KPMG as part of its 2005 SOX audit also related to the hedging area. Specifically, KPMG noted that the Company should not be applying the "change in variable cash flows method" per FAS 133 Implementation Issue No. G7 issued by the Derivatives Implementation Group ("DIG Issue G7").[511] Cash flow hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a cash flow hedge be reported in OCI and the ineffective portion be reported in current earnings. The Company stated in its documentation that cash flow hedge ineffectiveness for certain Euro Dollar futures contracts would be measured using the

[510] After Mary Malloy was hired as the Vice President for Hedging in late 2005, New Century's hedging policies, procedures and practices began to improve. In December 2006, the Asset and Liability Committee approved a comprehensive hedging policy document that addressed all of the areas missing from the Company's 2003 version of the policy.

[511] KPMG also reported that New Century's hedge documentation inadequately explained the specific methods and valuation approaches used by the Company to measure ineffectiveness.

change in variable cash flows method as specified in DIG Issue G7. [512] However, the guidance in DIG Issue G7 is applicable to interest rate swaps – not Euro Dollar futures contracts.[513]

Even assuming DIG Issue G7 is applicable to Euro Dollar futures contracts, the use of the change in variable cash flows method would be questionable because these financial instruments are entirely different. A Euro Dollar futures contract fixes LIBOR for only a three-month period while a swap generally fixes LIBOR for the entire life of the contract. Accordingly, in addition to the change in the variable cash flows, there would be a change in fixed cash flows that would need to be considered. This issue of incorrectly referring to the DIG Issue G7 method in its documentation was identified by KPMG during the year-end December 31, 2005 SOX audit and was noted as a significant deficiency in KPMG's management letter to New Century.

KPMG also noted additional deficiencies with New Century's hedging documentation practices in 2004 and 2005. For example, KPMG concluded that the Company's hedge accounting policy documents did not specifically address the manner in which ineffective portions of the changes in the fair values of derivatives accumulated in OCI would be reclassified into current earnings. In certain circumstances, this level of detail is required by FAS 133.

KPMG also raised an issue with New Century's effectiveness testing methodology. As noted above, cash flow hedge accounting requires that, at the inception of the hedge (and on an ongoing basis), the hedging relationship be highly effective in achieving an offset of the cash flows attributable to the hedged risk during the term of the hedge. New Century tested prospective effectiveness at inception using statistical regression analysis and, on an ongoing basis, using sensitivity analysis.[514] The Company concluded these were acceptable statistical methods. However, in the summer of 2006, KPMG questioned the propriety of the use of sensitivity analysis to perform the ongoing prospective testing because FAS 133 requires "regression or other statistical analysis."

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[512] Although New Century's hedge documentation states that the change in variable cash flows method was used, it appears that the hypothetical derivative method actually was used to measure hedge ineffectiveness. The hypothetical derivative method is an acceptable method to measure ineffectiveness.

[513] The Company maintained that using a series of Euro Dollar futures contracts was akin to an interest rate swap because, from an economic standpoint, both instruments are construed in a similar fashion. However, DIG Issue G7 only refers to interest rate swaps.

[514] The Company's retrospective effectiveness testing was performed using statistical regression analysis.

ii. New Century's designation documentation was not prepared "contemporaneously" with inception of hedge relationship

New Century's policy was to designate selected derivatives as hedges of specified risks at the inception of the hedge relationship, which was generally when the Company assumed risk (*e.g.*, at the origination of a loan held for sale or the completion of an on-balance sheet securitization). The Company's policy also stated that the hedge relationship must be shown to be effective both at the inception of the hedge relationship and on an ongoing basis. The methods used to test effectiveness at the inception of the hedge relationship and on an ongoing basis, and to measure hedge ineffectiveness, were specified in the Company's hedge designation memoranda.[515]

FAS 133 requires that hedge documentation be prepared "contemporaneously" with the inception of the hedging relationship. Data provided to the Examiner reflect that in certain transactions the required documentation was not prepared within an acceptable timeframe. A June 2005 internal KPMG e-mail states that the first quarter of 2005 hedging documents provided by the Company for the quarterly review were all "DRAFT documents."

The term "contemporaneous" is not defined within FAS 133. The SEC has not established a precise definition of contemporaneous in this context, but generally has held companies to a strict interpretation of the rule and required sufficient documentation at inception or within days thereafter in order to maintain eligibility for hedge accounting treatment. "DRAFT" documents containing no indication of management review and/or approval could not reasonably be considered to be contemporaneous within the meaning of FAS 133 and applicable SEC guidance, particularly because the Examiner has not seen evidence that finalized documentation ever was prepared or provided to KPMG. The failure to prepare adequate hedge designation documentation "contemporaneously" with inception is a violation of FAS 133 and results in the loss of hedge accounting treatment for the hedge transaction at issue.[516]

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[515] Under FAS 133, hedge documentation must be prepared for each hedging relationship.

[516] As noted above, many of the FAS 133 requirements are open to reasonable interpretation. However, if the SEC concluded that adequate designation documentation was not prepared contemporaneously with the inception of the hedging transaction, the SEC would not allow hedge accounting treatment for that particular transaction.

iii. New Century's hedge accounting practices in 2005 resulted in dispute with KPMG and subsequent audit adjustment

Prior to the filing of New Century's Form 10-K for 2005, KPMG's hedging specialist raised a number of issues with respect to the sufficient of the Company's hedge accounting practices. In his interview with the Examiner, John Klinge, a member of KPMG's Financial Derivatives Resources ("FDR") group, stated that, as of March 16, 2006, the date the Company filed its Form 10-K for 2005, he had not seen sufficient evidence to (1) understand how the Company was reclassifying amounts from OCI and to determine that the method employed was appropriate; and (2) support the probability of future outstanding debt balances in light of volatile prepayment speeds. Klinge told the Examiner that he subsequently received sufficient information to make that determination. However, Klinge could not recall what specific information was provided to him.

Interviews with other KPMG professionals and a review of the relevant documents revealed that Klinge appears to have been under significant pressure from his colleagues (in particular, Donovan) to permit the Form 10-K for 2005 filing to proceed as scheduled and to ignore his concerns regarding the Company's policy documentation and other deficiencies. Based on a review of the information obtained during the investigation, the Examiner has concluded that Klinge's assessment of the Company's documentation in early March 2006 appears to have been accurate and that there was a basis for his two primary concerns about New Century's hedging practices. Specifically, the Company appears to have failed to describe properly and in accordance with the accounting documentation how it would reclassify the ineffectiveness portion of the hedges. In addition, New Century did not support how it had projected cash flows in light of the volatile prepayment speeds that it experienced on its outstanding debt balances.

In the first quarter of 2006, New Century booked an audit adjustment of $3.7 million to account for the first issue raised by Klinge about OCI effectiveness and an audit adjustment of $7.6 million to account for the second issue raised by Klinge based on the Company's inability to accurately estimate future debt balance beyond 24 months. In effect, New Century conceded that it had made errors in the hedge accounting reflected in its 2005 Form 10-K. In addition to these audit adjustments, New Century changed its hedge accounting in the second quarter of 2006 to adopt the approaches recommended by Klinge.

iv. New Century's 2005 accounting for irlc was inaccurate

New Century disclosed in the notes to its December 31, 2005 financial statements that IRLC were recorded at fair value with changes in fair value recognized in current period earnings.[517] However, the Company was not accounting for IRLC on their subprime loans (the overall majority of their originations) as derivatives under FAS 133. In effect, New Century was not considering the value of the IRLC in its financial statements. Thus, the footnote disclosure was inaccurate and New Century did not comply with the FAS 133 requirement to account for the fair value of IRLC.

Upon discovering the non-GAAP accounting approach in its audit, the KPMG engagement team concluded that the potential financial statement impact of the departure from GAAP was immaterial. The engagement team's view was based on their understanding that two-year swap rates (which is one of the components generally used by a company valuing IRLC) "DID NOT move considerably between 11/1/05 and 12/31/05." The KPMG engagement team prepared a memo in April 2006 which estimated the potential financial statement impact of this accounting error at between $300,000 and $875,000. The brief memo focuses on the swap rate change over time (not its volatility) and fails to explain why only the 2-year swap rate, as opposed to 5 or 10 year rates, was considered. In his interview with the Examiner, Klinge said that the swap rate was the most significant factor in the valuation of the IRLC. However, he also acknowledged that other factors (including the pull-through rate and credit risk) impact the valuation of IRLC, and that it was the responsibility of the engagement team to assess and document its conclusion on materiality in light of all these factors.

g. KPMG's Audit Planning in Connection with Hedge Accounting

KPMG's substantive audit procedures were determined by its assessment of risk. KPMG assessed the inherent risk and control risk for the audit objectives and provided a rationale for the related assessments. Based on these assessments, KPMG assessed the risk of significant misstatement ("RoSM") arising from an error for each audit objective. The level of RoSM determines the nature, timing and extent of the audit procedures to be applied, which are documented in the audit program for each area.

[517] Form 10-K for 2005 at 88, F-24, and F-50.

KPMG's audit risk assessment for the derivatives instruments and derivatives gains and losses for the December 31, 2004 was "moderate." The "moderate" assessment was based on the positive results of the tests of design and tests of operating effectiveness performed on the controls related to the derivative accounts. The December 31, 2005 audit program for the hedging area also ranked the level of RoSM as "moderate." Inherent risk was assessed at "moderate" because of the potential impact on the income statement due to interest rate fluctuations and control risk was assessed as "effective."

According to the hedging audit program for the December 31, 2006 incomplete audit, the RoSM was identified as "high" for that year because the audit engagement team determined that:

- Control risk was "non effective;" and
- Inherent risk was "significant" because KPMG deemed the accounting rules pertaining to hedge effectiveness and measurement of ineffectiveness as complex.

While KPMG's assessment of controls as "non effective" in 2006 supported the RoSM of "High," it is unclear why KPMG did not identify the significant risks sooner, particularly given the number of control deficiencies in the hedging area identified in prior years. The Company's hedging practices do not appear to have deteriorated from 2005 to 2006.

h. Examiner's Conclusions Regarding Hedge Accounting

Hedge accounting is complex, requires extensive documentation and often involves a high degree of subjectivity in determining whether there has been compliance with FAS 133. The Examiner's investigation revealed a number of deficiencies with respect to the Company's hedge accounting policies and practices. Most, if not all, of these issues were identified and documented by KPMG at some point during the course of their audits and reviews, but the reaction by KPMG to these deficiencies was not effective. Many of these deficiencies are reflective generally of the Company's weak documentation and other internal controls. In addition, the hedging dispute arising from the filing of the Form 10-K for 2005 raises a number of concerns about KPMG's conduct that are discussed in other sections of this Final Report.

5. New Century's Accounting for Goodwill

a. Executive Summary

In the fall of 2005, New Century recorded more than $75 million in goodwill on its balance sheet as a result of its acquisition of the prime mortgage platform of RBC Mortgage ("RBC"). The former RBC business unit performed more poorly in the last four months of 2005 than had been expected. When New Century closed its books at the end of 2005, it undertook a

limited review of the valuation of the goodwill recorded in connection with its acquisition from RBC. The Company concluded, on the basis of limited testing, that the goodwill it had recorded was not "impaired," and, therefore, that no reduction in goodwill and no corresponding charge against current earnings were necessary. KPMG, on the basis of its own limited testing as part of the 2005 audit, reached the same conclusion.

The Examiner has concluded that the limited testing of goodwill that the Company and KPMG performed at year-end 2005 rested upon assumptions that were not adequately documented by New Century and not adequately questioned by KPMG. A change in those assumptions might have led to a substantial reduction in the goodwill reflected on New Century's 2005 balance sheet as well as a corresponding reduction in the earnings that New Century reported for 2005. Although substantial impairment of goodwill so soon after an acquisition might be considered unlikely, the Company's failure to document adequately the assumptions upon which its assessment of impairment of goodwill relied—violated applicable accounting principles and make it impossible for the Examiner to determine whether an impairment might have been required at year-end 2005.

b. New Century's Acquisition of RBC's Prime Mortgage Platform

As part of an effort to diversify and expand its product line, New Century acquired the loan origination platform of the prime mortgage retail division of RBC in September 2005 for $80.6 million.[518] Because this purchase price substantially exceeded the value of the net tangible assets that New Century acquired from RBC, New Century allocated $77.7 million of the purchase price to goodwill in recognition of the fact that one of the Company's primary business purposes in undertaking this transaction was to acquire RBC's established name and position in the prime mortgage loan market, its work force and other intangible assets.

According to Dodge, New Century conducted several forecasts to determine the amount of goodwill associated with its acquisition from RBC because New Century knew it would book significant goodwill as a result of that transaction. She said that the Company's most

[518] New Century purchased the assets of RBC through its Home123 subsidiary, which it had previously acquired for $4.0 million in May 2004. New Century booked $2.8 million of goodwill in connection with its acquisition of Home123, but the Examiner's investigation only focused on the goodwill booked in connection with the RBC transaction because this was the only acquired asset that the Company tested for impairment, and the only acquisition for which an undetected impairment could have resulted in a material misstatement of the Company's financial statements.

conservative forecast supported a goodwill allocation of approximately $75 million. At least one knowledgeable person, however, believed that New Century may have overpaid RBC for the tangible and intangible assets it acquired. Jonathan Threadgill, who had been a senior executive at RBC at the time of the acquisition and who subsequently joined New Century to help run the prime mortgage platform, thought that New Century's management did not understand the prime mortgage business and failed to appreciate the differences between the prime and subprime mortgage markets.

c. The Prime Mortgage Platform Performed More Poorly than Expected

During the four months after New Century acquired the prime mortgage platform, it sustained losses of $17.2 million, which was worse than New Century had forecasted. The "Originations and Sales" part of the MD&A section of New Century's 2005 Form 10-K, which was filed on March 16, 2006, disclosed these greater losses with the following description:

> [D]uring the fourth quarter of 2005, we closed $2.5 billion in loans through the origination platform recently acquired from RBC Mortgage and acted as a broker for an additional $382.8 million to third parties. As we previously expected, these operations negatively impacted our net income in 2005, including certain integration costs. While the loss was modestly greater than anticipated, we expect that the origination platform will be profitable in 2006.[519]

Even after New Century filed its 2005 Form 10-K, New Century's senior financial officers understood that the former RBC unit might not perform as New Century had hoped. In late-April 2006, Dodge warned that the prime mortgage division would need to have a profitable quarter soon or New Century would come under pressure to consider impairment of the goodwill that New Century had booked the previous fall. By the fourth quarter of 2006, Sanchez was suggesting that the Company consider a goodwill impairment because the prime mortgage platform was performing so poorly. This suggestion was rejected, at least initially, by Bindra and others.

d. Accounting Principles that Governed New Century's Goodwill Valuation and the Impairment Testing of that Goodwill Valuation

One of the accounting standards that applies to goodwill and to goodwill impairment is FAS 142, Goodwill and Other Intangible Assets, which requires a company to book any

[519] Form 10-K for 2005, p. 57-58.

difference between the price paid and the value of the assets acquired (minus liabilities) in an acquisition as goodwill on its financial statements.[520] FAS 142 also requires a company to assess its valuation of goodwill at least annually to ensure that the company is not carrying its goodwill at an amount that exceeds its implied fair value.[521] When the carrying amount of goodwill on a company's books exceeds the implied fair value of that goodwill, an impairment results.[522] If goodwill is determined to be impaired, the company must take an impairment charge against current earnings equal to the difference between the implied fair value of its goodwill and the amount at which it is carrying goodwill on its financial statements.

A company must use a two-step test to identify potential goodwill impairment and to measure the amount of goodwill impairment loss to be recognized (if any).[523] First, a company must compare the fair value of the business unit that was acquired with its carrying amount.[524] Ideally, the fair value of that business unit would be based on quoted market prices.[525] FAS 142 outlines alternative methods for the valuation of a business unit if quoted market prices are not available.[526] Those alternative methods include valuations based on estimated cash flows. If the

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[520] A company initially must book goodwill under FAS 141, Business Combinations. FAS 141 ¶ 34.

[521] FAS 142 ¶ 26. The company may carry forward a detailed determination of fair value from one year to the next if all of the following are true: (1) the assets and liabilities have not changed significantly since the most recent fair value determination; (2) the most recent fair value determination resulted in an amount that exceeded the carrying amount by a substantial margin; and (3) based on an analysis of events that have occurred and circumstances that have changed since the most recent fair value determination, the likelihood that a current fair value determination would be less than the current carrying amount of the reporting unit is remote. FAS 142 ¶ 27.

[522] FAS 142 ¶ 18. FAS 142 states that the fair value of goodwill can only be measured as a residual and cannot be measured directly. FAS 142 provides directions for determining a reasonable estimate of the value of goodwill for purposes of measuring impairment loss. That estimate is called the implied fair value of goodwill. FAS 142 Footnote 13.

[523] FAS 142 ¶ 18.

[524] FAS 142 ¶¶ 19 and 30.

[525] The fair value of an asset (or liability) is the amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, *i.e.* not in a forced or liquidation sale. The fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction. Quoted market prices in active markets are the best evidence of fair value and must be used as the basis for measurement, if available. FAS 142 ¶ 23.

[526] If quoted market prices are not available, the estimate of fair value must be based on the best information available, including prices for similar assets and liabilities and the results of using other valuation techniques. A present value technique is often the best available technique with which to estimate the fair value of a group of net assets (such as a reporting unit). If a present value technique is used to measure fair value, estimates of future cash flows used in that technique should be consistent with the objective of measuring fair value. Those cash flow estimates should incorporate assumptions that marketplace participants would use in their estimates of fair value. If that information is not available without undue cost and effort, an entity may use its own assumptions. Those cash

fair value of the applicable business unit exceeds its carrying amount, the company need not engage in a more detailed goodwill impairment analysis. If, however, the carrying amount of the business unit exceeds its fair value, the company must undertake a second, more detailed analysis to determine whether a goodwill impairment charge is necessary and, if so, the amount of that charge.[527]

This second step in the impairment analysis requires a company to engage in a complex allocation process in which the fair value of the reporting unit is allocated to all of the assets and liabilities of the unit. The remaining unallocated fair value is the new implied value of goodwill. This revised implied fair value of the goodwill associated with the relevant business unit is then compared with the carrying amount of that goodwill.[528] If the carrying amount of the business unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss must be recognized in an amount equal to that excess. If a company cannot complete the second step of the impairment test before its financial statements are issued, but can reasonably estimate the probable goodwill impairment loss, it must recognize the best estimate of that loss in its financial statements.[529]

e. New Century's Testing of Goodwill for Impairment in 2005

As part of the process of preparing its 2005 financial statements, New Century was required under FAS 142 to consider whether the $77.7 million[530] in goodwill it recognized in connection with its acquisition of the prime mortgage platform from RBC in September 2005 might be impaired.

Kenneally and Walker shared the view that the acquisition from RBC could not be analyzed properly until after an appropriate "start-up period" and that it was unnecessary to consider goodwill impairment so soon after the acquisition had closed. Nevertheless, to comply with FAS 142, New Century's Accounting staff undertook the first step in determining whether a goodwill impairment was necessary by estimating the current fair value of the former RBC unit. Given that there were no market prices for determining that business unit's fair value, the

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flow estimates should be based on reasonable and supportable assumptions and should consider all available evidence. FAS 142 ¶ 24.

[527] FAS 142 ¶ 19.

[528] FAS 142 ¶ 20.

[529] FAS 142 ¶ 22.

[530] Due to a purchase price allocation in Q4 2005, the Company's goodwill balance at 12/31/05 was $77.4 million.

Accounting staff modeled its future expected cash flows and discounted those cash flows to a present value figure. Although this methodology was consistent with FAS 142,[531] its accuracy heavily depended upon two key sets of assumptions: (1) the future revenues and profit margins the prime mortgage platform was projected to generate; and (2) the discount rate used in the model.

The revenue projections upon which New Century relied in connection with its 2005 goodwill impairment testing were not well documented, and the discount rate the Company's cash flow model used is subject to question. For instance, it is not clear if or how those revenue projections were adjusted in light of the substantial losses that the prime mortgage platform suffered in the last four months of 2005. Furthermore, although New Century used a 15% discount rate to calculate the net present value of the prime mortgage platform's projected cash flows for purposes of its impairment analysis, at approximately the same time, New Century's senior financial officers were using a more conservative 20% discount rate when internally analyzing the prime mortgage platform's future business plans.

Based on the revenue projections and discount rate that New Century's Accounting staff used in conducting the initial goodwill impairment test required under FAS 142, the Company determined that the fair value of the former RBC business unit exceeded the amount at which that business unit was being carried on the Company's books as of the end of 2005. As a result, the Company concluded that no further goodwill impairment analysis was necessary. As discussed below, it does not appear that the Company could have reached this conclusion had it used a 20% discount rate in the first stage of its impairment testing.

f. KPMG's Audit of New Century's 2005 Goodwill Impairment Testing

Donovan and Kim shared the view of New Century's senior accounting officers that the 2005 audit was too soon to assess the goodwill that New Century had booked in connection with its acquisition from RBC in September 2005. Even though they understood that the prime mortgage business unit had suffered significant losses in 2005, Donovan and Kim thought that less than four months was too short a period of time to gather data from which to draw conclusions about the prime business unit's future prospects.

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[531] FAS 142 ¶ 24.

As a result, although KPMG conducted some goodwill impairment testing in connection with the 2005 audit, it does not appear that senior people on the KPMG engagement team gave this goodwill impairment testing much consideration. According to KPMG's workpapers, the engagement team analyzed certain calculations in the Company's goodwill valuation by checking the mathematical accuracy of the computations in the fair value cash flow model and by inquiring about the nature of certain assumptions the model used. It does not appear that KPMG tested or questioned, with any degree of skepticism, the Company's underlying revenue and gross profit projections for the prime mortgage platform. KPMG did not document its understanding of the source of those revenue projections or its understanding of the business unit's ability to achieve those projections. Indeed, because the acquisition from RBC had occurred so recently, Donovan was not even concerned about the prime mortgage platform's cash flow projections.

Kim acknowledged that KPMG should have tested the revenue projections New Century used in its goodwill impairment test, but he could not identify any workpapers documenting that KPMG had conducted such testing. He could not recall whether or how KPMG's engagement team assessed the propriety of the assumptions used in New Century's cash flow model for the prime mortgage business unit. He assumed that KPMG reviewed those assumptions for reasonableness because there was a description of those assumptions in KPMG's workpapers, and because he assumed the engagement team performed sufficient analysis to justify its conclusions. Kim's assumptions are not supported by any documentation or by notes in the workpapers themselves.

Thus, on the basis of a discounted cash flow analysis that relied upon revenue projections that KPMG did not question seriously, the engagement team determined that the fair value of the prime mortgage business unit exceeded its carrying value on New Century's books, and, as a result, no further goodwill impairment testing was required under FAS 142 at year-end 2005.

g. Examiner's Conclusions Regarding New Century's Accounting for Goodwill

The Examiner concludes that the Company's year-end 2005 assessment of the goodwill associated with its acquisition of RBC relied upon unsupported cash flow projections and a questionable discount rate. The Examiner's investigation did not discover adequate evidence to support the revenue projections and other assumptions upon which New Century's 2005

goodwill impairment testing was based. At a minimum, however, the absence of such evidence raises documentation and internal control issues.

More importantly, the 15% discount rate used in the Company's goodwill testing is questionable given that senior financial executives were simultaneously using a 20% discount rate when internally analyzing the prime mortgage platform's business prospects. The Examiner has determined that, had New Century used a 20% discount rate in its initial goodwill impairment test for year-end 2005, the fair value of the former RBC business unit would have been less than the amount at which the business unit was carried on New Century's books and that additional goodwill impairment testing would have been required in accordance with FAS 142. By using a 15% discount rate, it appears that New Century avoided the full two-step goodwill impairment testing that FAS 142 requires. The Examiner did not have access to enough information to determine whether more complete goodwill impairment testing would have resulted ultimately in an impairment charge as of year-end 2005, but the Examiner concludes that New Century was not in compliance with the requirements of FAS 142 by not conducting that testing.

VII. MATERIALITY OF THE IDENTIFIED MISSTATEMENTS

A. Executive Summary

As discussed above, the Examiner has estimated that New Century's financial statements were misstated for at least the year ended December 31, 2005 and the quarters ended March 31, 2006, June 30, 2006, and September 30, 2006 (collectively referred throughout as the "four periods"). In order to fulfill his responsibilities under the Court's June 1 Order, however, the Examiner not only needed to identify accounting and financial statement irregularities, errors or misstatements, but he also had to determine whether those misstatements were material, such that the Company's 2005 and 2006 financial statements could not be relied upon and needed to be restated.

The Examiner has considered whether the identified misstatements were material according to the relevant accounting standards and professional guidance. The Examiner also has considered KPMG's internal benchmarks of materiality for audits and reviews of New Century's financial statements. The Examiner concludes that at least the allowance for loan repurchase losses, the LOCOM valuation allowance for LHFS, and the valuation of residual interests were materially misstated based on an evaluation of quantitative and qualitative factors. As a result of these material misstatements New Century:

- overstated its reported pre-tax earnings for each of the four periods by at least $63.6 million, $7.4 million, $75.6 million and $116.4 million, respectively;
- met analysts' earnings expectations for 2005 and the first quarter of 2006 when it should have announced earnings below expectations;
- paid bonuses for 2005 financial performance to the three founders of New Century, Cole, Gotschall and Morrice that were at least 300% higher than they should have been;[532]
- paid bonuses to other officers of New Century for 2005 financial performance that were approximately 130% to 270% higher than they should have been;
- reported an increase in EPS of eight percent for the second quarter of 2006 as compared to the second quarter of 2005 when it should have reported a minimum of a 40% decline in EPS;
- reported a profit in the third quarter of 2006 of $63.5 million when New Century should have reported a loss in that quarter;

[532] The Examiner assumes that the bonuses referenced in this section were actually paid because they were approved by New Century's Compensation Committee, as reflected in the minutes of the meetings of the Committee.

- understated its repurchase reserve by as much as 1000% in the third quarter of 2006;
- overstated its earnings by at least 129% in the third quarter of 2006; and
- paid mid-year bonuses to Cole, Gotschall and Morrice in 2006 when none should have been paid; and paying quarterly bonuses in 2006 to other officers that likely should not have been paid.

B. Applicable Standards

In evaluating the materiality of the errors in New Century's financial statements, the Examiner considered the definition of materiality in the professional literature, the guidance provided by the SEC staff, the guidance in GAAS and the materiality thresholds used by KPMG in its audit of New Century's December 31, 2005 financial statements.[533] As discussed in further detail below, these guidelines require companies and independent auditors to consider qualitative and quantitative factors when assessing the materiality of a misstatement and to evaluate that misstatement in light of the relevant facts and circumstances.

1. FASCON 2 and GAAS

The Financial Accounting Standards Board ("FASB") issued a conceptual statement in 1980, FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, ("FASCON 2"), which focuses in part on materiality. FASCON 2 defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."[534] While recognizing that materiality has a central quantitative component,[535] FASCON 2 cautions that the "magnitude of a misstatement, without considering the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment."[536]

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[533] In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, which was codified as SAB Topic 1.N, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements.

[534] FASCON 2, Glossary of Terms – Materiality, at p. 10. *See also id.* at ¶¶ 123-132 (discussing materiality in greater depth).

[535] *Id.* at ¶ 156 ("Though the definition of materiality is not substantially changed, ***its quantitative character is now given a more central position***, enabling the distinction between materiality and relevance to be stated more clearly . . . "[M]ateriality depends primarily on the ***size*** of the judgment item in particular circumstances").

[536] *Id.* at p. 7.

The definition of materiality in GAAS, which relies in part on FASCON 2, also is instructive. Among other things, GAAS specifies that "[f]inancial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles."[537] GAAS acknowledges that materiality judgments are made in light of surrounding circumstances and involve consideration of both quantitative and qualitative factors and that "misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements."[538]

2. SEC Guidance

SAB was issued in August 1999 in response to increasing concerns among SEC staff that management and auditors were relying too heavily, if not exclusively, on quantitative benchmarks to evaluate materiality. Among other things, SAB 99 attempts to dispel any misconception that there is a set numerical threshold for materiality or that small intentional accounting errors can be excused as immaterial. SAB 99 was not intended to change professional standards, and it does not provide an exhaustive list of all the factors that need to be considered in evaluating materiality. Nonetheless, SAB 99 does provide clarity in this highly judgmental area.

SAB 99 specifies that exclusive reliance on a percentage or numerical threshold is not appropriate. Nevertheless, the use of a percentage as a numerical threshold (for example, five percent of net income) may provide a basis for a preliminary quantitative assessment that misstatements less than such threshold are unlikely to be material. Such a threshold, however, should not be used as a substitute for a full analysis of all relevant considerations.

Consistent with the principles contained in FASCON 2, however, SAB 99 specifies that an assessment of materiality requires an evaluation of the facts in the context of the surrounding circumstances because qualitative factors may cause quantitatively small misstatements to be material. In the context of a misstatement of a financial statement item, this includes consideration of both the size in numerical or percentage terms of the misstatement, as well as the factual context in which the user of financial statements would view the financial statement

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[537] *AICPA Professional Standards*, Audit Risk and Materiality in Conducting an Audit ("AU § 312"), AU § 312.04.

[538] AU § 312.11.

item. SAB 99 provides examples of some of the qualitative factors to consider. In relevant part, these factors include whether the misstatement:

- hides a failure to meet analysts' consensus expectations for the company;
- arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- masks a change in earnings or other trends;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the company's business that has been identified as playing a significant role in its operations or profitability; and/or
- has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or incentive compensation.

SAB 99 also instructs that management and auditors need to first consider the quantitative and qualitative aspects of each individual misstatement in relation to relevant financial statement line item amounts, subtotals or totals. Second, they should consider the aggregate of the misstatements to those financial statement captions.

C. Analysis of the Identified Misstatements: Evaluation of the Quantitative and Qualitative Factors

The Examiner first considered whether the estimated misstatements were quantitatively material. As recognized in SAB 99, management and auditors commonly apply a five percent rule of thumb when reviewing the impact of an estimated misstatement on the financial statements. Using this five percent benchmark, the Examiner concluded that, for each of the four periods, the misstatements were quantitatively material with respect to the income statement as a whole, as well as with respect to the gain on sale of mortgage loans. Moreover, KPMG would have deemed the misstatements material for year-end 2005 and for each quarter of 2006, according to its own internal guidelines. In addition to assessing quantitative materiality, the Examiner considered the factors outlined in SAB 99 and concluded that the impact of the misstatements are qualitatively material.

1. Misstatements Identified by the Examiner

As discussed in Section VI.B., the Examiner has determined that New Century overvalued its residual interests in securitizations by no less than $42.3 million, $28.2 million, $43.4 million and $72.5 million for year-end 2005 and the first through third quarters of 2006, respectively. With respect to New Century's repurchase reserve, as discussed in Section VI.A., the Examiner has determined that New Century was under-reserved by $11.5 million, $24.4

million, $21.4 million and $104.8 million for each of those same reporting periods, respectively. In addition, New Century's LOCOM account was understated by $9.8 million, $18.4 million, $81.9 million and $85.8 million, respectively.

2. Income Statement Impact

The Examiner evaluated the quantitative materiality of the misstatements in the aggregate compared to the income statement as a whole, as well as to individual line items, *e.g.*, gain on sale. The Examiner evaluated the impact to gain on sale because it is a significant line item and all of the misstatements at issue would have impacted the reported gain on sale. The Examiner's analysis is detailed in Tables 1 and 2, below.

Table 1: Impact on Earnings[539]

	Year Ended 12/31/05[540]	Quarter Ended 3/31/06[541]	Quarter Ended 6/30/06	Quarter Ended 9/30/06
Reported earnings before income taxes[542]	$443.4[543]	$115.7	$134.8	$90.2
Increases (decreases) to earnings for the following identified misstatements[544]**:**				
Allowance for repurchase losses[545]	(11.5)	(12.9)	3.0	(83.4)
LOCOM valuation allowance[546]	(9.8)	(8.6)	(63.4)	(3.9)
Valuation of residual interests[547]	(42.3)[548]	14.1	(15.2)	(29.1)
Total identified misstatements	(63.6)	(7.4)	(75.6)	(116.4)
Revised earnings before income taxes	***$379.8***	***$108.3***	***$59.2***	***($26.2)***
% Change	**(14.3%)**	**(6.4%)**	**(56.1%)**	**(129.1%)**

[539] Estimated balance sheet impact may differ slightly from amounts reflected on "Table 1: Impact on Earnings" due to rounding discrepancies.

[540] During its 2005 year-end audit, KPMG identified misstatements of about $9.6 million related to hedging and other income statement accounts that were not corrected by New Century Management. If corrected, these misstatements would have resulted in additional pre-tax earnings for that year of $9.6 million. During its March 31, 2006 quarterly review, KPMG's SFG identified an error in the model that was used to value the 2005-B NIMs at December 31, 2005. The impact of this misstatement on the residual interests balance at December 31, 2005 was an overstatement of approximately $9 million. New Century corrected this misstatement during the first quarter 2006. The Examiner did not consider these two misstatements in the materiality analysis at December 31, 2005 because their impact to earnings essentially offset each other. While not all of the uncorrected hedging misstatements identified by KPMG at December 31, 2005 would reverse and entirely offset the effects of the $9 million error for the 2005-B securitization, the Examiner considered that during the first quarter of 2006, New Century decided to remediate the hedging deficiencies and, as a result, recorded one-time adjustments (increases to pre-tax earnings) aggregating $11.3 million. These one-time adjustments more than offset the effects of the $9 million error for the 2005-B securitization corrected during the first quarter of 2006.

[541] *Id.*

[542] These figures were taken from New Century's Form 10-K for 2005 and Form 10-Qs for the first three quarters of 2006.

[543] All figures are in millions.

[544] The effects of the misstatements on New Century's pre-tax earnings were computed as the difference between the asset or liability amounts determined by the Examiner and amounts reported by the Company in its financial statements. Differences for the year ended December 31, 2005 were reflected in annual pre-tax earnings in their entirety. In determining the effects on pre-tax earnings in subsequent periods, the Examiner took into consideration any misstatements reflected in previous periods. As a result, the amounts that were added or subtracted from the income statement per quarter are not equal to the amount of the minimum misstatement that the Examiner found to exist as of that period end.

[545] *See* Section [Repurchase Reserves].

[546] *See id.*

[547] *See* Section [Residual Interests].

[548] The 12/31/05 financial statements report a value for residuals that is $2.7 million less than the amount reported in the Company's year-end internal Quarterly Residual Asset Valuation Report.

Table 1 shows that for the four periods, New Century's pre-tax earnings were overstated by at least 6.4% to 129.1%. Significantly, in the third quarter of 2006, New Century's reported financial statements reflect positive pre-tax earnings of $90.2 million. Had the financial statements been reported accurately, this number would not have been a positive number but would have reflected negative earnings of $26.2 million.

Table 2: Impact on Reported Gain on Sale

	Year Ended 12/31/05[549]	Quarter Ended 3/31/06[550]	Quarter Ended 6/30/06	Quarter Ended 9/30/06
Reported gain on sale of mortgage loans[551]	$622.6[552]	129.5	195.2	173.0
Increases (decreases) to gain on sale for the following identified misstatements[553]:				
Allowance for repurchase losses[554]	(11.5)	(12.9)	3.0	(83.4)
LOCOM valuation allowance[555]	(9.8)	(8.6)	(63.4)	(3.9)
Valuation of residual interests[556]	(42.3)[557]	14.1	(15.2)	(29.1)
Total identified misstatements	(63.6)	(7.4)	(75.6)	(116.4)
Revised gain on sale of mortgage loans	***$559.0***	***$122.1***	***$119.6***	***$56.6***
% Change	**(10.2%)**	**(5.7%)**	**(38.7%)**	**(67.3%)**

As illustrated in Table 2, above, the Examiner also finds that the material misstatements caused New Century to overstate by a material amount its reported gain on sale during each of the four periods.

3. Balance Sheet Impact

In assessing quantitative materiality, the Examiner also considered the impact of the misstatements on New Century's balance sheet and determined the following:

- New Century's repurchase reserve was understated by at least 208%, 350%, 178%, and 1000% for the four periods, respectively.

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[549] *See* n. 540.

[550] *See* n. 541.

[551] *See* n. 542.

[552] *See* n. 543.

[553] *See* n. 544.

[554] *See* n. 545.

[555] *Id.*

[556] *See* n. 547.

[557] *See* n. 548.

- New Century's LOCOM valuation account was understated by at least 105% and 215% at December 31, 2005 and March 31, 2006. There was no LOCOM valuation amount for June 30, 2006 or September 30, 2006, when such amounts should have been $81.9 million and $85.8 million, respectively.
- Residual interests were overvalued by at least 17%, 13%, 20%, and 32% for the four periods, respectively.

4. Impact to Reported Net Earnings and EPS

Finally, the Examiner also calculated the impact of the misstatements on New Century's net earnings and EPS. As reflected in Table 3 below, the Examiner has determined the following:

- The misstatements resulted in New Century meeting analysts' earnings expectations for year-end 2005 and the first quarter of 2006, when it otherwise would have had to announce earnings that were at least three to four percent below the bottom range of analysts' estimates.
- For the second quarter of 2006, New Century reported an increase in EPS of eight percent. The Examiner finds that, instead, the Company's earnings actually dropped by at least 40% in that period over the prior comparable period.
- If the financial statement had been accurate, the Company would no longer have been reporting a profit as of the quarter ended September 30, 2006. Instead of posting a profit of $63.5 million, New Century would have reported a loss of at least $6.3 million.

Table 3: Estimated Impact on Earnings per Share[558]

	Year Ended 12/31/05[559]	Quarter Ended 3/31/06[560]	Quarter Ended 6/30/06	Quarter Ended 9/30/06
Reported net earnings available to common shareholder ("CSH")[561]	$411.1[562]	$101.2	$103.0	$63.5
Identified misstatements – tax effected at 40%[563]	(38.2)	(4.4)	(45.4)	(69.8)
Revised net earnings available to CSH	***372.9***	***96.8***	***57.6***	***(6.3)***
Reported basic earnings per share	7.42	1.82	1.85	1.14
Revised basic earnings per share	***6.73***	***1.74***	***1.03***	***(0.11)***
% overstated	9%	4%	44%	110%
Reported diluted earnings per share	7.17	1.79	1.81	1.12
Revised diluted earnings per share	***6.51***	***1.71***	***1.01***	***(0.11)***
% overstated	9%	4%	44%	110%
Reported basic EPS for the comparable prior period:	10.20	1.55	1.71	2.10
Trend - % change as reported	(27%)	17%	8%	(46%)
Trend - % change as revised	***(34%)***	***12%***	***(40%)***	***(105%)***
Reported diluted EPS for the comparable prior period:	8.29	1.48	1.65	2.04
Trend - % change as reported	(14%)	21%	10%	(45%)
Trend - % change as revised	***(22%)***	***15%***	***(39%)***	***(105%)***
Analysts' estimates[564]	$6.73 – $8.88	$1.78 – $1.79	$1.85 – $1.89	$1.65 – $1.98
% revised diluted EPS below analysts' estimates	***3% - 27%***	***4% - 5%***	***45% - 46%***	***106% - 107%***

[558] *See* footnotes for Table 1.

[559] *See* n. 540.

[560] *See* n. 541.

[561] *See* n. 542.

[562] *See* n. 543.

[563] The Examiner reviewed the tax rates in the financial statements filed by New Century and believes that 40% is approximately the rate that had been applied by the Company previously to New Century TRS Holdings, Inc, which is where these corrections would have been reported. The Examiner has insufficient information to calculate accurately the appropriate tax rates since such a calculation needs to be performed considering the taxable status of the entity, the various tax jurisdictions, and whether any of the tax benefits considered can be realized.

[564] The December 31, 2005 analysts' estimates were derived from various equity research firms. The quarterly 2006 estimates were derived from research from Goldman Sachs, Morgan Stanley, and Merrill Lynch.

5. Discussion of Other Factors

As demonstrated in Tables 1, 2 and 3 above, the misstatements had a significant impact on New Century's financial statements. The Examiner has also evaluated two other relevant factors outlined in SAB 99. First, the estimated misstatements are related to three areas—valuation of residual interests, allowance for repurchase reserves, and allowance for LOCOM—that New Century identified in its public filings as critical accounting policies. In other words, the estimated misstatements were in areas that were both important to the portrayal of a company's financial condition and results and required subjective or complex judgments.

Second, the Examiner evaluated the impact of the misstatements on Management's incentive compensation. Specifically, to the extent that the Examiner was able to determine the formulas on which the bonuses were based, the Examiner recalculated the bonuses based on the revised earnings figures set forth above. The Examiner has determined that the bonuses paid to several executives were significantly affected by the material misstatements in 2005 and 2006.

Specifically, for 2005 performance, Cole, Gotschall and Morrice each received bonuses that were at least approximately 300% higher than they would have been if the year-end financial statements had not been misstated. They each received a bonus of $1,070,236. If the Company's financial statements had been more accurate, the bonus each received should have been, at most, $354,736. Similarly, Flanagan's bonus was at least approximately 270% higher than it should have been and Cloyd's was inflated by at least approximately 130%. In total, at least $3.2 million of the bonuses paid by New Century in 2005 should not have been paid based on the estimated revised quarterly earnings figures.

During 2006, Cole, Gotschall and Morrice received mid-year bonuses of $693,016 each based on the Company's 2006 performance to date. If the interim financial statements had not been materially misstated, they would not have received any bonuses for that time period. While the Examiner did not recalculate the bonuses for other New Century executives in 2005 and 2006 because the Examiner was not provided a description of the formulas on which their compensation was based, it is likely that those bonuses also would have been impacted significantly by the misstatements at issue, as they also had a component that was tied to earnings.

Based on the foregoing analysis, the Examiner concludes that the misstatements were material to New Century's financial statements for each of the four periods. The misstatements

were not only material, but they served to mask significantly the financial difficulties that the Company was facing for many months before the Debtors filed for bankruptcy.

VIII. INTERNAL CONTROLS OVER FINANCIAL REPORTING

A. Introduction

As a reporting company subject to the Securities Exchange Act of 1934, New Century was required to establish and maintain a system of internal controls over financial reporting sufficient to provide reasonable assurances that, among other things, transactions were recorded as necessary to permit the preparation of financial statements in conformance with GAAP.[565] Under SOX Section 404 ("SOX 404"), New Century's Management was responsible for assessing the effectiveness of its internal controls over financial reporting as of each year-end financial reporting period between 2004 and 2006.[566] In addition, New Century's independent auditor, KPMG, was retained to audit and express an opinion on Management's assessment of internal financial controls and on the effectiveness of those internal financial controls as of each year-end financial reporting period between 2004 and 2006.[567]

This Section of the Report provides an overview of the SOX 404 review process undertaken by New Century for the fiscal years ending 2004 through 2006, the relevant findings of Management over that time period, and the conclusions the Examiner has drawn with respect to the sufficiency of New Century's internal controls over financial reporting. The Examiner concludes that deeply-rooted and long-standing failures to establish and monitor adequate internal controls over financial reporting substantially contributed to New Century's accounting errors. Many of these control failures relate to the lack of written and effective policies and procedures for calculating accounting estimates. The Examiner is unable to determine with any certainty the impact that more rigorous controls would have had at specific points in time on the accuracy of New Century's financial statements, but believes that weak internals controls in all likelihood contributed to the occurrence of the repurchase reserve, residual interest and other accounting errors and allowed those errors, to remain undetected.

The Examiner was mindful of the need to seek to assess New Century's internal controls as they existed during the relevant time periods, without the benefit of hindsight. Toward this end, the Examiner engaged in a year-over-year comparison of control deficiencies identified by

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[565] *See* 15 U. S. C. § 78m(b)(2)(B).

[566] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. at 789 (codified at 15 U.S.C. § 7262).

[567] *Id.* KPMG resigned prior to completing its SOX 404 audit work for the 2006 year-end period, but it completed substantial testwork and reached some interim conclusions with respect to deficiencies in internal controls that are discussed further herein.

Management and KPMG for several of New Century's significant accounts (such as the repurchase reserve, residual interest valuation, and certain other accounting matters discussed in this Final Report). The Examiner did not, however, review every single control deficiency identified during the SOX review process, but instead focused on the more significant control deficiencies.

B. Summary of Findings

The Examiner has identified a number of deficiencies concerning New Century's internal controls over financial reporting during the period covered by the 2004 through 2006 audits and the adequacy of the SOX assessment conducted by New Century. The most significant deficiencies are as follows:

- New Century failed to develop effective policies and procedures for performing accounting estimates requiring the exercise of considerable judgment. This created an environment devoid of safeguards that enabled the Accounting and Secondary Marketing Departments to revise certain accounting practices and related assumptions without adequate review and oversight. This led to material errors with various accounting matters, including the repurchase reserve and residual interest valuation. For example, in early 2006, the Secondary Marketing Department stopped updating the prepayment and loss rate assumptions used in its pre-2003 valuation models without any process controls in place to make certain that such inaction was warranted. Similarly, in the second and third quarters of 2006, Kenneally made several changes in the way that New Century calculated the repurchase reserve without notifying the Audit Committee.
- New Century did not remediate internal control deficiencies that existed at year-end 2004 and year-end 2005, despite representing to KPMG that it would. Many of these recurring deficiencies can be characterized as documentation issues. When viewed in isolation, they may seem insignificant. However, in the aggregate, these deficiencies demonstrate that New Century had poor documentation practices and weak internal controls in areas critical to its financial reporting, including the repurchase reserve, residual interest valuation and hedging process. The recurrence of such internal control deficiencies during the 2004 through 2006 SOX reviews also indicates that New Century's Senior Management was not effective in promoting a strong compliance culture.
- New Century lacked adequate internal controls to log, process and track all repurchase requests presented to the Company, thereby creating a significant risk that the number of repurchase claims pending would not be identified accurately or processed efficiently. This contributed to the development of a significant backlog of outstanding repurchase requests. New Century also lacked adequate controls to ensure that the existence and magnitude of this backlog was factored into the repurchase reserve estimate. Neither Management's nor KPMG's SOX review identified these control deficiencies in the repurchase reserve processes.

- New Century did not devote sufficient internal resources to the SOX assessment process. New Century budgeted for at least three full-time SOX auditors, but never filled any of these positions. New Century outsourced substantially all of Management's assessment effort, and the evidence strongly suggests that Management did not perform a detailed analysis of the severity of the deficiencies identified by its consultant Ernst & Young ("E&Y"). In addition, New Century's Management failed to cooperate with some reasonable information requests made by KPMG as part of its SOX audits.[568]

C. Analysis of Management's Annual SOX 404 Assessment of the Effectiveness of Internal Control Over Financial Reporting

SOX 404 requires management to produce an "internal control report" as part of each annual Form 10-K filing with the SEC.[569] This report must affirm "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[570] In addition, the report must contain "an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."[571] SOX also requires management to evaluate any changes in internal controls that occurred during a fiscal quarter and that have materially affected, or are reasonably likely to materially affect, the entity's internal controls over financial reporting.[572]

To ensure that management is accountable for its assessment of the adequacy of internal financial controls, Section 302 of SOX requires principal executive officers and principal financial officers to certify in Form 10-K and 10-Q filings that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the company...is made known to such officers or to others within [the entity], particularly during the period in which the periodic reports are being prepared."[573] The certifications must provide that all significant deficiencies and material

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[568] New Century refused KPMG's repeated requests during the 2006 audit to provide any written explanation of its rationale for determining the likelihood or potential magnitude of any misstatement that could result from the failure of identified control deficiencies. Also, in late 2006, Kenneally prevented the release to KPMG of Asset and Liability Committee ("ALCO") Committee meeting minutes because the minutes did not evidence required discussion and approval of the assumptions used in the residual interest valuation models.

[569] Pub. L. No. 107-204, § 404, 116 Stat. at 789 (codified at 15 U.S.C. § 7262).

[570] *Id.*

[571] *Id.*

[572] 17 CFR § 240.13a-15 (2003).

[573] *See* 15 U.S.C. § 7241(a)(4).

weaknesses in the design or operation of internal controls over financial reporting which could adversely affect the issuer's ability to record, process, summarize and report financial data have been disclosed.

During the relevant time period at New Century, Section 302 certifications were filed by Robert Cole, Brad Morrice, Edward Gotschall (for periods prior to 2006) and Dodge. To support their certifications, New Century established a mini-certification process whereby various senior managers, including Kenneally and Licata, provided internal certifications with respect to controls within their areas of responsibility to support the executive certifications. New Century also established a Disclosure Committee, comprised of various members of Senior Management, which met every quarter to consider (among other things) internal controls and the mini-certification process.

As discussed in Section VIII. of this Final Report, the 2004 through 2006 KPMG audits of New Century's internal controls over financial reporting were governed by Auditing Standard No. 2. ("AS 2") of the Public Company Accounting Oversight Board ("PCAOB"). AS 2 requires the independent auditor to inform the audit client of all significant deficiencies and material weaknesses existing at the end of the client's annual financial reporting period. AS 2 defines a significant deficiency as "an internal control deficiency or combination of control deficiencies that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP such that there is a more-than-remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected." AS 2 defines a material weakness as "a significant deficiency or combination of significant deficiencies that result in a more-than-remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

1. New Century's Assessment Process in 2004

The first year of SOX 404 review at New Century covered the year ending December 31, 2004. New Century's 2004 SOX compliance effort was the primary responsibility of the Company's Controller, Kenneally, and Accounting Manager, Trevor Drummond, who were responsible for identifying key financial accounts and for ensuring that adequate documentation, testing and evaluation of the relevant internal controls over those accounts was performed by New Century's SOX contractors. New Century formed a committee to oversee Management's

SOX 404 compliance effort (the "SOX 404 Committee").[574] The SOX 404 Committee members included Patti Dodge, Kenneally, Terry Theologides, Jennifer Jewett, Joseph Tortorelli, Paul Zalle and George Arambula.[575] The members of the SOX 404 Committee from the Internal Audit Department, Zalle and Arambula, played significant roles in coordinating New Century's SOX work and regularly apprised the Audit Committee of progress. However, neither of them engaged in any substantive review work.

During the 2004 SOX implementation process, New Century retained E&Y to assist with documentation, testing, and remediation of the various internal control processes associated with key financial reporting accounts. New Century relied heavily on E&Y to prepare the necessary documentation, evaluate process controls and conduct the testwork required for Management's initial assessment of the sufficiency of its internal controls. E&Y did not express any professional opinion on the adequacy of New Century's internal controls. In addition, New Century retained Grant Thornton to remediate deficiencies in the information technology ("IT") general controls and to assist with Management's SOX review of the income tax and REIT processes.

KPMG's 2004 audit of New Century's internal controls over financial reporting ("SOX 404 audit") was integrated with KPMG's audit of New Century's financial statements ("substantive audit"). Kinsella served as the partner in charge of KPMG's integrated audit engagement in 2004. Significant roles were played by Tara Hatanaka (manager) and Athena Chan (junior manager). A separate consulting team from KPMG also had a limited role in preparing some of New Century's SOX documentation in 2004. The objective of the KPMG consulting engagement was to "assist [New Century] in documenting its internal control over financial reporting for in-scope process/locations [as determined by Management], and provide observations and recommendations." The Examiner could find no indication that KPMG provided New Century with any observations or recommendations in connection with this work. KPMG's assistance to New Century in this regard does not appear to raise any significant auditor independence problems because of the limited scope of KPMG's work, its use of a separate

[574] The Examiner's inquiry observed that the following names were used interchangeably to refer to this committee: "Compliance Committee," "SOX Compliance Steering Committee," "SOX Oversight Committee," and "SOX 404 Committee."

[575] Although the SOX 404 Committee prepared frequent status reports to the Audit Committee, the Examiner was only able to locate an agenda and meeting minutes for a July 7, 2005 meeting of the SOX 404 Committee.

internal audit group (rather than the audit engagement team) to perform this work, and the approval of this work by New Century's Audit Committee.

Upon completing its SOX review for 2004, New Century identified 104 process control deficiencies and an additional 66 IT general control deficiencies. KPMG identified 10 additional process control deficiencies and 31 additional IT general control deficiencies after reviewing Management's results, evaluating any remediation performed by Management and completing its own independent testwork.

KPMG determined that New Century remediated most of these deficiencies by the end of 2004. On March 15, 2005, in accordance with its responsibility under AS 2, KPMG issued a letter to New Century's Management describing five significant deficiencies in internal control over financial reporting. These deficiencies were as follows:

> Management neglected to create adequate documentation evidencing the appropriate application of GAAP in certain areas. These areas included the allowance for loan loss methodology and rationale, the accounting treatment for securitization transactions (sale vs. financing), the accounting for forward loan sale commitments and the accounting for investments in affiliates. This deficiency was evidenced by the Carrington securitization transaction, which should have been recognized as a financing rather than a sale in the second quarter. Though underlying information existed and several of these areas were remediated at year end, financial management needs to instill the discipline to effectively document the accounting rationale for all significant accounting matters.
>
> Management neglected to create adequate documentation supporting data inputs for Secondary Marketing's calculation of residual values and the loss curves used in determining the allowance for loan losses. This includes collateral data reconciliation and certification of expected cash flows. This information is necessary to support the review process of such calculations to help ensure data integrity underlying the calculations. This was remediated at year end.
>
> Management neglected to have an appropriate reconciliation of certain liability accounts related to derivatives and a full understanding of the margin account activity with the investment broker, resulting in a $30.9 million adjustment from Other Comprehensive Income (OC1) to Other Liabilities. This adjustment was necessary to reflect the OCI existing upon the termination of a Euro Dollar futures contract in the fourth quarter.
>
> The Company's reconciliation and review process was not complete when we were provided with tax balance sheet account documentation. A roll forward of deferred taxes was prepared arriving at the ending inventory. However, in order to help ensure that the resulting inventory is accurate, the Company should validate each deferred tax item at period end with supporting documentation.

> Additionally, the Company should reconcile the period end current tax receivable and other tax accounts on a timely basis.
>
> With respect to the period-end financial reporting process, management neglected to create adequate documentation to evidence the review of information provided by other departments prior to being sent to Financial Reporting. This was remediated at year end.[576]

In its Management letter, KPMG did not identify any material weaknesses in internal controls over financial reporting. Therefore, KPMG issued an "unqualified" SOX 404 audit opinion for 2004. However, in addition to the significant deficiencies listed above, KPMG attached an appendix to its Management letter setting forth additional, unremediated control deficiencies identified during the course of the SOX 404 audit that it categorized as either inconsequential or documentation deficiencies.

Quite reasonably, New Century appears to have taken great comfort from obtaining a "clean" opinion from KPMG on its internal controls in 2004. In a March 2005 e-mail to various members of Senior Management, Zalle lauded the Company's receipt of "an unqualified, clean opinion...[on its] financial reporting processes and controls." His message contrasted New Century's "very successful result" with that of contemporaneous adverse SOX reports identifying material weaknesses at two other public companies. The minutes from a May 2005 Audit Committee meeting reflect Zalle representing that "the Corporation's SOX 404 compliance effort in 2004 confirmed the Corporation's internal control over financial reporting was working effectively." Other members of Senior Management, including Dodge, informed the Examiner that New Century took considerable comfort in the fact that it had "passed" its SOX audit.

2. Management's Assessment Process in 2005

To coordinate Management's SOX 404 compliance review in 2005, New Century hired an outside consultant, Bruce Polk. His role was to interface among Management (including its contractor, E&Y), the Internal Audit Department and the independent auditors from KPMG. Tony Sanchez, who joined the Company in 2005, became a member of the SOX 404 Committee and played an important role in the 2005 SOX review. New Century continued to rely upon the consulting services of E&Y to perform substantially all of Management's documentation, review

[576] These KPMG findings were reported to the Audit Committee on March 10, 2005. On May 16 2005, KPMG reported to the Audit Committee that Management had remediated most of these significant deficiencies by year-end.

and testing of internal controls over financial reporting. KPMG continued in its role as New Century's independent auditor.[577]

At the beginning of 2005, in accordance with the engagement partner rotation requirements of SOX, KPMG assigned Donovan to replace Kinsella as the engagement partner on the New Century audit team. The audit team also experienced additional turnover from the prior year as a result of other personnel changes. Debbie Biddle, a new in-charge senior associate, replaced Chan in March 2005. In June 2005, KPMG hired Mark Kim to fill the senior manager position on the New Century engagement vacated by Tara Hatanaka in February 2005.

KPMG managed and staffed the 2005 SOX work using various members of the engagement team. Biddle simultaneously managed the SOX process and also served as the in-charge senior associate for the substantive audit. Until December 2004, Biddle served as an assistant manager in KPMG's Birmingham, UK office. She joined the New Century engagement shortly after beginning a rotation in KPMG's Los Angeles office. Biddle had extremely limited experience with SOX and U.S. GAAP issues prior to beginning her work on the New Century audit.

In 2005, New Century identified 84 control deficiencies after completing its SOX review. KPMG identified an additional 10 control deficiencies in 2005. KPMG also identified 18 IT general control deficiencies. However, as of year-end 2005, KPMG only identified one significant deficiency relating to hedge documentation. KPMG concluded that all other deficiencies were either remediated by year-end or did not rise to the level of a "significant deficiency" that required a report to New Century's Audit Committee.

Specifically, KPMG's 2005 SOX letter to the Audit Committee described the significant deficiency as follows:

- Management's hedge documentation for On Balance Sheet securitizations is inconsistent with their current accounting method used to calculate ineffectiveness and reverse effective amounts out of Other Comprehensive Income (OCI) into earnings, resulting in an audit difference of $9.7 million. Based on the nature of the Company's dynamic hedging relationship, the Company should not be applying the "change in variable cash flows method" per Statement 133 Implementation Issue No. G7 issued by the Derivatives Implementation Group (DIG G7). Additionally, Management's hedge documentation does not include details related to the specific methods and

[577] In contrast to 2004, KPMG did not provide documentation assistance or otherwise assist Management in its assessment of internal controls in the 2005 or 2006 reviews.

valuation approaches used to measure ineffectiveness. This specific level of detail is critical given Management's application of DIG G7 to the Company's dynamic hedging relationship."

In the above-referenced 2005 letter to the Audit Committee, KPMG did not identify a significant deficiency relating to accounting documentation problems at New Century, as it had done in the prior year. In its 2004 Management letter, KPMG reported that "Management neglected to create adequate documentation evidencing the appropriate application of GAAP in certain areas." KPMG also specifically noted in that 2004 letter that New Century "financial management need[ed] to instill the discipline to effectively document the accounting rationale for all significant accounting matters." The same findings were not made in 2005, even though KPMG found in the 2005 SOX audit that New Century continued to lack written policies and procedures in several key accounting areas including allowance for loan losses, repurchase reserve, valuation of residual interests and hedging. There is no sufficient explanation for why a different conclusion was reached by KPMG in 2005.

3. Management's Assessment Process in 2006

In 2006, New Century conducted its SOX review with the same degree of reliance on E&Y. Polk continued in his role as SOX coordinator. The key members of Management's effort continued to include Kenneally and Sanchez. Conversely, KPMG's management of the SOX audit changed considerably. Rather than rely on the same senior associate to manage both the substantive and the internal controls aspects of the audit, KPMG assigned a dedicated SOX manager to the New Century engagement. This shift in staffing strategy occurred at the request of the engagement team's SEC concurring partner, Marc Macaulay. In April 2006, as part of KPMG's engagement risk assessment and approval process, Macaulay expressed concerns within KPMG about manager staffing on the engagement team. These concerns led to his temporary refusal to approve KPMG's undertaking of New Century's 2006 audit engagement. His concern was resolved (at least in part) by the addition of a manager whose focus was specific to the SOX component of the engagement.

Accordingly, the work performed by Biddle in 2005 was divided between two junior managers in 2006: Fiona Liang (substantive audit) and Veronica Wong (SOX audit). Wong had two full years of SOX experience and considerably more U.S. GAAP experience than Biddle. During her planning for the SOX audit, Wong engaged in a limited review of prior year

workpapers, relying extensively on Beckstrom and Kim (who continued in their roles from 2005 to 2006) to provide assistance with the identification of the client's key processes and controls.[578]

The 2006 SOX review was not completed because of KPMG's April 2007 resignation as New Century's independent auditor. Nonetheless, Management had substantially completed its assessment of internal controls, and KPMG was in the final stages of its review prior to resigning. By December 2006, Management submitted its preliminary control deficiency listing containing 100 deficiencies in various process areas (exceeding the 86 final deficiencies identified in the prior year). KPMG's Beckstrom (who had worked on both the 2004 and 2005 audits) exclaimed "Wow" in an e-mail to other members of the audit team in reaction to the extent of Management's initial deficiency list. Wong informed the Examiner that this level of deficiencies in the abstract was not necessarily unusual. In a November 2006 e-mail, however, Licata noted the following: "I'm surprised that there are issues as nothing has changed in our process year over year."

The Examiner has concluded, based on a review of the deficiency listings and related workpapers, that both KPMG and New Century exhibited increased diligence in their 2006 review of internal controls as compared to the prior year. New Century's control processes did not change significantly from 2005, yet the number of deficiencies grew substantially in 2006. Bruce Polk suggested that E&Y took a "deeper dive" on the SOX review in 2006, which probably accounted for the greater number of deficiencies identified by Management.

KPMG's more robust identification and review of controls may have been attributable in part to Wong's experience and resolve. Aided by her SOX expertise, Wong appears to have taken a closer review of New Century's deficiencies than Biddle did in 2005. For example, Wong insisted that Management provide written evidence of its assessment of control deficiencies as inconsequential, documentation issues, significant deficiencies or material weaknesses. Polk objected to Wong's request and indicated that New Century previously had not been asked to provide such information to KPMG. Indeed, KPMG's 2004 SOX workpapers confirm that although New Century performed a version of this severity analysis for 2004, it did not document this assessment. In 2005, Biddle did not raise the issue at all. In 2006, Wong felt that it was important enough that she continued to pursue the supporting documentation again in

[578] However, the Examiner was unable to locate any evidence in the 2006 KPMG workpapers of formal review by Beckstrom or Kim of prior year deficiencies.

December 2006 and January 2007 after her initial request was rebuffed in November.[579] She forwarded guidance to Polk explaining why she needed this information, and she ultimately indicated that she was flexible with respect to the format of the written documentation so long as Management provided an adequate rationale for its severity assessments. The issue was never resolved because of the February 2007 announcement about the accounting irregularities and KPMG's eventual resignation.

The initial list of deficiencies identified by Management and KPMG for 2006 is similar to prior years (although more deficiencies are identified and the IT control deficiencies appear to be more severe). After accounting problems with the repurchase reserve and residual interests valuation were discovered, KPMG prepared a conclusion memorandum in March 2007 that identified material weaknesses in four accounts (repurchase reserve, residual interests, allowance for loan losses and hedging) and significant deficiencies in two accounts (mortgage servicing rights and payroll). The memorandum, which reflected deficiencies that KPMG had not identified as material or significant until the restatement announcement was made in February 2007, was not finalized because of the subsequent resignation by KPMG.

D. Management's Commitment to the Assessment Process

New Century retained the professional services of E&Y to perform its documentation, evaluation and testing of internal controls. New Century also engaged the services of a professional SOX project manager in 2005 and retained other consultants to assist in the SOX review process. Nonetheless, the Examiner has concluded that New Century did not devote sufficient internal resources to the SOX compliance effort.

At the May 16, 2005 Audit Committee meeting, the SOX 404 Committee reported that it had been unsuccessful in filling three open SOX positions (SOX Project Director for the Finance Department, SOX Senior Auditor for the Internal Audit Department and a dedicated SOX Auditor for the Servicing Department) that had been authorized and budgeted for by New Century. The SOX 404 Committee attributed the hiring difficulty to the "tight job market for qualified SOX experienced personnel." However, in a May 11, 2005 e-mail, Kenneally admitted to Dodge that "we have had a couple of candidates submitted, but have not been 'actively' searching." In a handwritten note dated June 8, 2005 to Dodge, Zalle questioned Kenneally's

[579] In his interview with the Examiner, Donovan stated that he thought Wong's information request was a "good idea." However, contemporaneous correspondence indicates that Donovan did not actively support Wong's efforts to obtain this information from New Century.

commitment to the SOX review process, and expressed disappointment in his apparent passivity toward the recruitment effort for the SOX Finance Director. These three SOX positions were never filled.

As discussed throughout Section E below, New Century's lack of formal policies and procedures governing many of the accounting estimates requiring substantial judgment was frequently noted as an internal control deficiency by KPMG. Management failed to develop written and effective polices and procedures for these processes after these deficiencies were brought to its attention on a recurring basis. This epitomizes the lack of attention that Management gave to remediating internal control deficiencies.

In addition, the Examiner is troubled by at least two instances in which Management failed to respond appropriately to KPMG's reasonable requests for information during the SOX 404 audit process. As discussed in Section E.3.b, Kenneally obstructed an important portion of the SOX 404 audit by blocking the release of ALCO meeting minutes to KPMG. At best, Kenneally's action is inconsistent with that of a Controller who takes seriously his responsibility over ensuring the effectiveness of internal controls over New Century's financial reporting. The second instance, discussed in Section C.3 above, pertains to Wong's request for Management to provide written support for its assessment of the severity of deficiencies. Among the factors an auditor must consider in evaluating management's assessment process is whether management "evaluat[ed] the likelihood that failure of [a deficient] control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives."[580] Management repeatedly resisted Wong's reasonable request for documentation evidencing this evaluation, engaged in a finger-pointing exercise with E&Y over who was responsible for preparing such documentation, and ultimately provided nothing to KPMG. This refusal is an indication that, as late as January 2007, Management lacked the necessary commitment to the SOX review of its internal controls.

Also relevant to New Century's commitment to the effectiveness of its internal control over financial reporting is the likely overextension, of and over reliance upon, its Controller. As discussed above, New Century never managed to fill its vacant SOX positions. During KPMG's 2006 audit, Kim noted that "Dave [Kenneally] seems to know the answers for everything and anything and the rest of the accounting department is on almost the same boat as the audit team

[580] AS 2, ¶ 40.

is – little knowledge of what's going on." Similar comments were made by New Century employees. At various times, Dodge lamented that "Dave does too much," and Zalle questioned whether Kenneally had sufficient time to properly prioritize the SOX review. Indeed, even Kenneally remarked in a non-SOX related response to an inquiry from Donovan that "my time, your money...neither of us have enough." The SOX audit oversight responsibilities added to the mix of Kenneally's responsibilities and substantially increased the burden on an already busy individual.

E. Analysis of Internal Controls Over Key Financial Reporting Processes

1. Repurchase Reserve: Change in Methodology

A year-over-year analysis of the key controls surrounding the repurchase reserve estimation process reveals that New Century's Management permitted certain recurring deficiencies to remain unaddressed. Most importantly, Management never adopted detailed written policies and procedures for the repurchase reserve calculation process. As part of its 2004 SOX audit, KPMG agreed with Management's observation that New Century lacked formal documentation memorializing its methodology for estimating the repurchase reserve. In response to this finding, Management represented to KPMG that it was taking steps to formalize its "informal" and "undocumented" policies and procedures and would include timelines, checklists and retention policies in that documentation. This was never done.

During its 2005 SOX walk-through of the repurchase reserve estimation process, KPMG again noted that Management failed to adopt "formal policies and procedures" for calculating the repurchase reserve. During KPMG's 2006 SOX walk-through of the repurchase reserve estimation process, KPMG again noted that New Century lacked "formal policies and procedures" for calculating the repurchase reserve. According to KPMG's narrative from the walk-through, Kenneally represented to KPMG that "the memo on Repurchase Reserve policies will be updated near the end of the year."

In November 2005, Trevor Drummond of the Accounting Department submitted to KPMG a draft memorandum entitled "Allowance for Repurchase Losses." This brief memorandum provided a high-level summary of the purpose of the repurchase reserve and listed applicable accounting standards. However, the memorandum provided absolutely no explanation of how New Century calculated the repurchase reserve. In KPMG's view, this memorandum failed to remediate the control deficiency because its draft form indicated that

New Century never adopted it as Company policy. According to Biddle, "formal adoption" would have necessitated a more thorough consideration of the policy by New Century's Management. The memorandum also failed to explain New Century's repurchase reserve estimation process in any detail. It does not discuss any of the specific procedures followed by the Accounting Department to calculate the reserve, much less the rationale for using such procedures and any related assumptions in light of applicable accounting standards. It is evident that the memorandum was prepared in an unsuccessful attempt to satisfy KPMG's documentation request and not to establish clear and thorough procedures for calculating the reserve.

Despite the Company's failure to adopt adequate repurchase reserve policies and procedures for the second year in a row, KPMG concluded as part of its 2005 SOX audit that this deficiency was "inconsequential" and therefore did not report the deficiency to the Audit Committee. In support of its assessment, KPMG noted in its workpapers (without further explanation) that the Audit Committee's review of New Century's financial statements as a whole satisfactorily compensated for this documentation deficiency. In addition, Biddle told the Examiner that through KPMG's quarterly review of the repurchase reserve calculation, the audit team could observe and test other control points in New Century's process for calculating the repurchase reserve irrespective of whether policies and procedures were formally adopted. However, as discussed elsewhere in this Final Report, KPMG's engagement team failed to appreciate the impact of material, improper changes in the methodology for calculating the repurchase reserve that took place in the second and third quarters of 2006, despite KPMG's quarterly reviews. Thus, the observation and testing of other control points in the repurchase reserve estimation process did not enable the KPMG engagement team to identify the material error in the calculation methodology.

The Examiner believes that the lack of a detailed, written repurchase reserve policy with specific calculation and review procedures enabled Kenneally to have largely unrestrained discretion over changes to the reserve methodology in 2006. During his interview with the Examiner, Kenneally stated that he now believes that the 2006 changes to the repurchase reserve methodology probably should have been disclosed to the Audit Committee. An effective, detailed written policy governing the reserve estimation process would have required Kenneally to follow certain steps before making any changes to the methodology (such as obtaining the

review and approval of the Audit Committee or other members of Management). As a result, the proposed changes very likely would have been brought to the attention of the KPMG audit engagement partner (who denies he knew about the methodology changes at the time they were implemented). This likely would have prompted a review of such changes from a GAAP standpoint and may have prevented the material errors which were not discovered until early 2007.

The failure to develop effective policies and procedures for calculating the repurchase reserve is more than a technical documentation issue. It reflects the lack of adequate internal controls that New Century had in place to ensure that the repurchase reserve was being calculated on a consistent basis in accordance with GAAP. The Examiner has concluded that the existence of written and effective repurchase reserve estimation policies and procedures would have decreased the risk of an improper accounting error (which is one of the principal objectives for having such documentation controls) by imposing a review and approval framework that would have required Management and/or the Audit Committee to consider the rationale supporting the proposed changes and their consistency with GAAP. New Century's failure to develop and comply with such policies and procedures for calculating the repurchase reserve was at least a significant deficiency (if not a material weakness) in New Century's internal control environment that contributed to a material misstatement in its financial reports.

2. Whole Loan Sales: Backlog in Repurchase Claims Processing

a. New Century Failed to Establish Effective Controls to Facilitate the Flow of Information Between Departments Critical to Its Process for Handling, Forecasting and Reserving for Repurchase Claims.

In January 2007, New Century disclosed to KPMG that delayed processing of repurchase requests had allowed a substantial backlog of unresolved repurchase claims to build up throughout 2006. Kenneally informed both the Examiner and the SIC that he was unaware of the backlog and therefore did not consider it in the estimation of the repurchase reserve. However, documents from as early as June 2006 indicate that Kenneally was put on notice about the existence of a growing backlog of request requests. Licata told the Examiner that he "assumed" the Accounting Department knew about the backlog. Licata never took any steps, however, to ensure that Kenneally knew about the backlog or considered it as part of the repurchase reserve. Even if Kenneally may have known about the backlog of outstanding repurchase claims as early

as June 2006, the Secondary Marketing and Accounting Departments still failed to establish an effective process for tracking and sharing information about the backlog and for evaluating how it might be relevant to the repurchase reserve calculation.

In early 2007, KPMG characterized the failure of the Accounting and Secondary Marketing Departments to share information about the backlog as a material weakness in New Century's internal controls. According to Beckstrom, KPMG had not previously evaluated the adequacy of this specific control in its SOX review of the whole loan sales process because New Century had not identified a specific control point relating to the flow of repurchase claim information between the Secondary Marketing and Accounting Departments. As a result, KPMG asserts that it failed to identify the risk of misstatement in the repurchase reserve balance due to the lack of effective communication between those Departments. As discussed further in Section XI. below, KPMG actually requested and received information from New Century about the claims backlog as early as 2005.

During all relevant periods, the Secondary Marketing Department's policy manual included specific procedures for handing repurchase requests. For each repurchase claim, the procedure required that a repurchase specialist "log in the receipt of the request in a tracking spreadsheet on the [Company] network, obtain additional repurchase information from the investor if required, and complete a Repurchase Summary Form." Subsequently, the repurchase specialist was required to forward the request to "Loan Sales Management," which would determine whether an investigation was warranted.

Depending on the nature of the claim, repurchase requests requiring investigation were either forwarded to the Legal Department or to another member of the Secondary Marketing Department. Once the investigation was complete, a recommendation would be made to the Loan Sales Management Department. If the loan was designated for repurchase, a wire request was sent to the Accounting Department. Throughout the entire repurchase claims process, this transmittal of the wire request was the only point at which New Century's repurchase handling policy designated any role for the Accounting Department. Therefore, it does not appear that the Accounting Department received regular reports from the Secondary Marketing Department on the extent of repurchase claims made against the Company and the potential impact on the repurchase reserve.

b. New Century Failed to Follow Its Repurchase Procedures, Resulting in an Inability to Efficiently Process, Forecast, and Reserve for Repurchase Claims.

Despite this detailed policy, New Century's repurchase claims review process operated in a highly decentralized and informal manner. Repurchase requests often were received by the investor's most recent point of contact at the Company. Incoming requests would flow into the Secondary Marketing Department from various departments and then would be assigned to Legal, Secondary Marketing and other departments, as necessary, for review and approval or refutation. Secondary Marketing had primary responsibility for tracking repurchase claims, but other departments (including Legal) kept their own records and the lists did not always reconcile in terms of volume and/or status. Ron Brown of Secondary Marketing told the Examiner that the main problem with New Century's repurchase claim system prior to the fall of 2006 was that there was no centralized process to collect, track, and manage claims as they were received. In addition, Cloyd acknowledged that there was no one responsible for monitoring the operations of each repurchase agreement "because it was never a problem until March 2007."

Prior to 2005, Secondary Marketing's tracking mechanism consisted of a handwritten log of repurchase requests. A handwritten log failed to satisfy the requirements of New Century's policy, although it may have been sufficient for tracking a low volume of claims. As volume increased in 2005, Secondary Marketing attempted to streamline this process by tracking all requests in an Excel spreadsheet. This spreadsheet was created and maintained by the Transaction Management group (headed by Lent) within the Secondary Marketing Department. However, the process remained decentralized, with claims logged by various transaction managers within the Secondary Marketing Department and by other departments (including Legal), maintaining their own spreadsheets and not coordinating their findings.

By October 2006, the substantial volume of repurchase claims prompted New Century to establish a centralized repurchase desk ("Repurchase Desk") to more efficiently track and handle all repurchase claims.[581] The Repurchase Desk was staffed by representatives from the Legal, Secondary Marketing and other departments and had sole responsibility for reviewing and

[581] KPMG engagement team members (including Kim and Donovan) claim they were never informed about the establishment of the Repurchase Desk until early 2007 when New Century advised KPMG of the backlog issue. If true, the fact that KPMG did not learn about the creation of the Repurchase Desk (and the resulting changes to the repurchase claims tracking and handling process) as part of its SOX walkthrough in November 2006 strongly suggests that KPMG did not ask appropriate questions or otherwise conduct a sufficient examination of the Company's controls surrounding the repurchase claim process.

tracking the status of repurchase requests. New Century's failure to establish the Repurchase Desk until late 2006, after the trend of increasing repurchase claims was evident, reflects another internal control weakness in the repurchase process.

New Century's failure to establish an effective mechanism for tracking, processing and handling repurchase claims contributed to its inability to promptly detect the increasing volume and (staleness) of repurchase claims. This weak control environment led to the development of a substantial backlog of claims. In addition, the Secondary Marketing Department's failure to track and disclose the increased volume of unresolved repurchase claims precluded the Accounting Department from making adjustments to the reserve that could have taken into account the increased repurchase volume. New Century's failure to establish effective controls for handling repurchase claims prior to late 2006 prevented the Company from detecting early warnings about the development of the backlog. The Examiner has concluded that this was a material weakness in the control environment as early as 2005, when repurchase claims began to increase.[582]

3. Valuation of Residual Interests

New Century also failed to establish sufficient internal controls with respect to its residual interest valuation process. As with the repurchase reserve calculation, New Century did not begin to develop written policies and procedures for the residual interest valuation process until early 2007, after KPMG applied increasing pressure on New Century to substantiate various aspects of its valuation approach. In addition, New Century had weak controls surrounding the process used to determine and update various assumptions used in its valuation models. These internal control deficiencies are discussed in further detail below.

a. Importance of Internal Controls in Connection with the Residual Interest Valuation Process

New Century relied on Excel-based spreadsheet models to determine its residual interest in a particular securitization. Each securitization had a separate model. The models for different vintages of New Century securitizations were built by different people - the early models were built by John Kontoulis, the models between approximately 1998 and 2003 were built by Licata,

[582] The same control weaknesses existed in 2004, although it is less clear such weaknesses could have been characterized as "material" at that point given the size of the backlog that may have existed.

and the post-2003 models were built by Hatch. The models became more complex and sophisticated over time.

Each month, the Secondary Marketing Department would populate each securitization model with actual data. The model then would be rolled forward from the prior month to calculate the current residual interest based on various assumptions (including, most importantly, the prepayment rate, the loss rate, and the discount rate) that were built into the model at the outset. From time to time, these assumptions (particularly the prepayment rate and the loss rate) were updated by the Secondary Marketing Department. Such changes to the assumptions could have a material impact on the value of the residual interest. For example, Mullins told the Examiner that changes to the prepayment and loss assumptions would have the greatest impact on the valuation results and that, from time to time, he was asked by Licata to run the models with different assumptions.

As noted above, the design of the models gave the Secondary Marketing Department the ability to change the inputs and assumptions to achieve particular results. Therefore, to prevent and detect fraud and other errors in the calculation of the residual interest, it was imperative for New Century to have robust and effective controls in the residual interest valuation process. The residual interest value was an important component of New Century's balance sheet, and therefore rigorous controls were necessary to prevent improper assumptions or other procedures from being used intentionally or inadvertently.

b. Lack of Written Policies and Procedures for Determining Valuation of Residual Interests

As noted above, New Century failed to develop detailed, written policies and procedures for how it built, operated and updated the models it used to develop the residual interest valuation. New Century did not develop a manual which explained the design of the functions or routines within the valuation models. This was problematic because different vintages of the models were built by different people and therefore had different limitations and capabilities. In addition, New Century did not have written policies and procedures which set forth a methodology for establishing and changing assumptions within the models. This was an important control deficiency because the accuracy of the models depended on the reasonableness of the assumptions, which in turn depended on the exercise of judgment. Thus, these assumptions needed to be updated from time to time based on actual securitization performance and market trends. The lack of detailed policies and procedures for establishing and updating

those assumptions left New Century vulnerable to a high risk of misstatement from unreasonable assumptions because the models could be very sensitive to assumption changes..

c. "Key Man" Risk Exposure Resulting From Use of In-House Residual Interest Valuation Models

The post-2003 securitization models developed by John Hatch were more sophisticated than prior models built by Licata and Kontoulis, but nobody at New Century except Hatch understood fully how to design the post-2003 models or how they operated. New Century therefore exposed itself to considerable risk in the event that Hatch was not available to help operate, understand and interpret the models. This "key man" control weakness manifested itself in at least two important respects which are described below.

First, KPMG discovered an error in the first quarter of 2006 with respect to the PMI component of one of the 2005 securitization models. This error led to a $9 million write-down in the first quarter of 2006. According to Hatch, a "side table" that he had to build into the model to calculate the PMI (because the Excel spreadsheet did not have the capability to account for the PMI without the side table) was not working effectively. Had the Secondary Marketing analyst rolling the model forward understood as well as Hatch how the model at issue was built, it is likely that the error would have been discovered earlier or avoided altogether. Second, one of the residual interest controls put into place by New Century was a process for "third-party" valuation of the residual models on a quarterly basis by someone outside of the Secondary Marketing Department. Yuri Pyatigorsky from the Finance Department was tasked to perform this "third-party" validation role. The problem, however, was that Pyatigorsky could not understand the Microsoft Visual Basic for Applications ("VBA") logic that Hatch built into the post-2003 models.[583] Therefore, he was unable to review these models and the third-party validation process was an ineffective control.

d. Ineffective Security Controls for Residual Interest Valuation Models

New Century also had weak controls with respect to the security of its residual interest valuation models. The SOX reviews performed in 2004 and 2005 revealed that "inappropriate users have access to the structured finance folder" in which the valuation models were kept by

[583] The Examiner was informed that only Hatch and maybe Licata could understand the VBA routines in these models. Despite this limitation, no effort was made by New Century to have Licata review the models or to identify someone outside the Secondary Marketing Department who could provide adequate "third-party" validation of the relevant securitization models.

the Secondary Marketing Department. This meant that unauthorized personnel could access the models and change the inputs and assumptions. The Examiner did not perform a forensic analysis of whether unauthorized changes to the inputs or assumptions were made over the relevant period. In addition, the Examiner is not aware of any evidence suggesting that such unauthorized changes were made. Nonetheless, the Examiner notes that the absence of strong security controls in this area could have had a significant adverse impact on the accuracy of New Century's financial statements given the sensitivity of the models to input and assumption changes.

e. Lack of Effective Controls for Reviewing and Approving Modifications to Assumptions Used in Valuation Models

According to the written narratives developed by New Century as part of the SOX review process, and the documentation created by KPMG following its SOX walkthroughs, the ALCO was responsible for reviewing and approving any changes to the prepayment and loss assumptions in the valuation models. In practice, however, with the exception of the discount rate assumption, Licata decided if and when to make such assumption changes and there was no documented review or sign-off by ALCO on all assumption changes. The Examiner learned that during the 2006 SOX audit, KPMG repeatedly requested copies of the ALCO meeting minutes to verify that review and approval of the assumptions occurred (as stated in the narratives). However, KPMG never received these minutes. In an e-mail exchange initiated by Polk on November 16, 2006, Kenneally, Hatch, Sanchez, and Licata (among others) recognized that the ALCO meeting minutes did not reference any discussion of approving the assumptions for New Century's residual interest valuations. On December 11, 2006, KPMG attempted to obtain copies of the minutes from Kenneally's office. Kenneally told his assistant that he "would rather delay KPMG a little bit, because the minutes need some work." Upon learning that KPMG already had copied some of the minutes, Kenneally wrote "Actually, we will be fine. We lost the right minutes.... Please don't give them October either." KPMG repeated its requests throughout January, February and March 2007. Kenneally instructed his staff to invent excuses explaining the delay. Ultimately the minutes were never provided to KPMG because Kenneally specifically prevented their release.

Every month, Secondary Marketing analysts responsible for operating the models would roll the models forward with actual data, determine if prepayment and loss assumption changes were necessary based on any divergence between actual and projected performance, and then

discuss any proposed assumption changes with Licata, who exercised final decision-making authority. According to both Hatch and Mullins, Licata did not believe in making such assumption changes every month in response to deviations between actual and projected performance, but only would make changes after a clear trend had been established over several months.

The lack of any written policies and procedures for when to make changes in the prepayment and loss assumptions, and the lack of any review outside of the Secondary Marketing Department for decisions about the propriety of such assumption changes, facilitated Secondary Marketing's unilateral decision to stop making such assumption changes to the pre-2003 securitization models in early 2006. At a minimum, written policies and procedures providing thresholds for assumption changes and mandating a formal review process would have ensured additional vetting of the decision to stop updating the assumptions. Thus, the lack of formal policies and procedures gave the Secondary Marketing Department personnel the latitude to decide unilaterally not to update the pre-payment and loss assumptions as frequently as was necessary in 2005 and 2006. Therefore, the lack of effective controls in connection with the assumptions used in the models most likely prevented New Century from detecting residual valuation errors that had a material impact on its financial statements.

f. Lack of Effective Controls Relating to Clean-Up Calls

New Century also had no written policies and procedures in place to determine whether and when to exercise its optional termination rights when the collateral in a securitization fell below the "clean-up call" threshold (typically 10%). All of the residual interest valuation models used by New Century assumed that each securitization would be collapsed when the collateral reached the 10% clean-up call threshold. However, in practice, New Century routinely pushed out the collapse date in its models after reaching the threshold. New Century did not develop any written documentation explaining the rationale for such changes in the clean-up call assumption, and Secondary Marketing personnel in charge of the models had unfettered discretion to determine when to push out the call dates without review by the Securitization Committee or any other group within New Century. Licata explained to the Examiner that there was "no thought process" involved and that New Century would just push out the termination date if it was not ready to collapse a security that had fallen below the 10% or other applicable threshold. This lack of controls enabled New Century to engage in a practice which New

Century ultimately concluded (as part of the 2005 restatement) was unsupported and therefore was inconsistent with GAAP.

4. Allowance for Loan Losses

A year-over-year review of the SOX deficiency listing reveals that New Century never adopted adequate written documentation of its methodology and assumptions for determining the ALL provision. The ALL is not a transactional balance, but rather a judgmental estimate. Therefore, it is important to have strong internal controls in this area. In addition to the documentation deficiencies, the ALL provision was not consistently reviewed and approved by the appropriate individuals within the organization. In 2004, KPMG noted the following significant deficiencies relative to ALL and communicated them to New Century through a formal letter:

- "Management neglected to create adequate documentation evidencing the appropriate application of GAAP in certain areas. These areas included the allowance for loan loss methodology and rationale..."
- "Management neglected to create adequate documentation supporting data inputs for Secondary Marketing's calculation of residual values and the loss curves used in determining the allowance for loan losses...."

During the 2005 SOX audit, KPMG's workpapers indicate that the ALL methodology deficiency persisted. However, this deficiency was viewed as inconsequential by KPMG. There is no explanation for why the ALL documentation deficiency was reported as a significant deficiency in 2004 and was deemed inconsequential in 2005. In its December 2006 deficiency listing, KPMG observed that New Century still lacked a "documented/written policy detailing the Allowance for Loan Loss methodology."

In its March 2007 draft SOX memorandum, prepared after the February restatement announcement, KPMG concluded that, when aggregated, the ALL deficiencies likely constituted a material weakness. KPMG specifically noted the following:

> At the end of 2006 the Company had a loss provision of approximately $204.5 million. Given the materiality of the provision and the high degree of subjectivity in estimating an adequate ALL, and the above deficiencies identified by Management – i.e. [lack of] proper documentation describing its methodology and assumptions, lack of evidence of review of the gain/loss calculation for a sample securitized deal, we determined that we would not rely upon the Company's [internal controls] in contemplation of the extent of our substantive audit procedures. We also determined that specialist involvement would be necessary.

Earlier in the 2006 audit, KPMG's engagement team requested assistance from KPMG's FRM practice. A draft memorandum from a FRM specialist dated December 2006 for the period ending May 31, 2006 listed the above deficiencies, and stated that "[c]ompared to other industry participants in mortgage lending that both develop securitization net loss assumptions and ALL balances, [New Century] does not use or apply industry best practice modeling methods. [New Century's] net loss estimates are based upon static vectors that are unresponsive to changes in delinquency and environmental factors."

The Examiner finds it difficult to believe that the substantial control deficiencies with the ALL noted in 2006, which are similar to deficiencies noted in 2004, were remediated, documented and tested in 2005, and then subsequently became deficient again in 2006. The Examiner therefore concludes that Management did not sufficiently test and evaluate the severity of, and KPMG did not sufficiently review, the ALL controls during the 2005 SOX audit.

5. Mortgage Servicing Rights

Neither Management nor KPMG identified any internal control deficiencies in the process for valuation of MSR assets for year-end 2004 and 2005. However, in its 2006 draft deficiency memorandum, KPMG identified a significant deficiency relating to the MSR valuation. Specifically, KPMG noted the following:

> The Company does not have a valuation model to support its MSR valuation assessment for lower of cost or market determination for servicing assets. The Company calculates its MSR valuation by taking a fixed [basis point] multiple of total unpaid collateral balance. During 2006, the Company used 70 [basis points] as its valuation multiple based on the amount recorded by the Company for loan sales made to Carrington. The Company does not have documentation to support the valuation used.

The Examiner is unaware of any material changes that occurred in the MSR valuation process between 2004 and 2006. In 2005, KPMG's SFG specialists raised issues with the engagement team relating to the MSR valuation process during the substantive audit. However, the engagement team declined to raise these issues with Management. These same concerns surfaced during the 2006 SOX 404 audit, in the form of the significant deficiency noted above. New Century's failure to develop an MSR valuation model appears to be a potentially significant deficiency that was not remedied despite concerns expressed by KPMG.

6. Hedging

Over a three year period, beginning in 2004 and ending in 2006, KPMG noted a number of deficiencies related to the Company's internal controls for the hedging and derivatives process. Many of the deficiencies related to the Company's inadequate documentation of its hedging policies and procedures, including the lack of a comprehensive policy, inadequate designation documentation at inception and inadequate documentation in support of effectiveness testing of its hedging relationships. In addition to the documentation issues, KPMG noted a number of other deficiencies related to the Company's reconciliation procedures, spreadsheet controls, valuation procedures and approval procedures. The non-documentation deficiencies reflected ineffective controls in procedures used to calculate the financial impact of hedging and derivative transactions. In addition, the documentation deficiencies raised concerns about the adequacy of New Century's control environmental in the hedging area particularly since FAS 133 requires considerable documentation to substantiate the use of hedge accounting treatment.

For the year ended December 31, 2004, four non-documentation deficiencies (out of a total of six deficiencies) were identified by KPMG in the hedging area. For the year ended December 31, 2005, six of the 12 deficiencies identified related to non-documentation issues. For the year ended December 31, 2006, eight of 11 deficiencies identified by KPMG during the incomplete SOX review related to non-documentation issues. For example, KPMG noted in 2006 that New Century lacked proper segregation of duties with respect to derivative trading (one individual could enter, verify, and confirm a trade).[584]

Based on the Examiner's review of the available data, it does not appear that New Century placed much emphasis on improving its controls related to the hedging and derivatives process. To the contrary, the control deficiencies appear to have worsened over time, both in volume and significance. As noted above, KPMG identified a significant deficiency with New Century's controls in the hedging area in 2004 and 2005. Both of these significant deficiencies resulted in audit adjustments. During its incomplete 2006 SOX audit, KPMG reached the preliminary conclusion that there was a material weakness in new Century's hedging control

[584] The higher number of deficiencies noted by KPMG in 2005 and 2006 may be explained by KPMG's use of SFG specialists to review internal controls in the hedging and derivatives area in 2005 and 2006 (but not 2004). The 2006 findings also reflect a SOX review of RBC mortgages activities for the first time.

environment as a result of the aggregation of deficiencies (many of which were recurring from prior years).

7. Information Technology Controls

A typical SOX 404 review includes a detailed internal control evaluation of all information systems that impact financial reporting. The information technology controls are categorized as either Information Technology General Controls ("ITGC") or application controls. ITGC describe the general overall IT controls for key systems such as backup and disaster recovery, whereas application controls concern specific IT applications or processes (*e.g.*, evaluating whether a particular calculation is functioning as it should).

KPMG engaged its Information Resources Management ("IRM") specialists to conduct the SOX review of New Century's information systems. The impression obtained by the Examiner from IRM's findings is consistent with the results of the other SOX process areas. New Century failed to establish specific policies and procedures to prevent unauthorized access to systems, models and sensitive documents. These control deficiencies suggest a permissive environment that was not sufficiently designed to prevent or detect the possibility of fraud or other accounting errors. For instance, New Century neglected to adequately secure sensitive information within the shared Accounting Department folder. Accordingly, unauthorized individuals could access, and potentially manipulate or misuse, such data. This deficiency existed in 2004, 2005, and 2006.

The Examiner is not aware of any evidence establishing that unauthorized access to New Century's information systems enabled the perpetration of fraud or other intentional misconduct. However, the recurrence of such basic security deficiencies is illustrative of New Century's general disregard for ensuring the adequacy of internal controls over financial reporting.

8. Company-Level Controls

Company-level controls include those "controls that exist at the company-level often hav[ing] a pervasive impact on controls at the process, transaction, or application level."[585] Examples of company-level controls include items that apply to all locations and business units within the company, such as codes of conduct, company policies and procedures and the assignment of authority within the company. Professional standards encourage auditors to evaluate the effectiveness of these company-level controls at the outset of an audit so that the

[585] AS 2, paragraph 52.

results may inform the auditors in planning for the review of process-level and transaction-level controls.

In 2004, neither Management nor KPMG identified any company-level control deficiencies at New Century. In 2005, Management noted five company-level control deficiencies which were all reported to have been remediated by year-end. These control deficiencies were: (i) lack of evidence of acknowledgement by certain employees of the Company's Code of Conduct; (ii) lack of an Internal Audit charter; (iii) lack of evidence of the date Senior Management signed the quarterly financial certifications; (iv) lack of updated policies and procedures in the Company's online policy library; and (v) lack of a consistent policy regarding documenting Executive Management Committee meeting minutes.

The SOX review for 2006 was not completed. However, the deficiency list provided by Management following all of its testing included two control deficiencies relating to company-level controls: (i) lack of evidence of acknowledgement by certain employees of the Company's Code of Conduct; and (ii) lack of updated policies and procedures on the Company's intranet. Both of these control deficiencies existed in 2005 and were reported by New Century to have been remediated by year-end 2005. Although KPMG did not identify any company-level control weaknesses in its draft internal control deficiency letter relating to its incomplete 2006 SOX review, Management's detection of these same two deficiencies in 2006 reinforces the Examiner's conclusion that New Century did not take its remediation obligations as seriously as it should have done.

IX. DISCLOSURE CONTROLS

A. Executive Summary

SOX and SEC rules mandate that SEC reporting companies maintain "disclosure controls and procedures" to ensure that information required to be disclosed in SEC filings is processed and reported in a timely and accurate manner. As a result of the accounting issues that led New Century to determine that a financial restatement was necessary, New Century concluded in February 2007 that its disclosure controls and procedures had probably been ineffective.

In its February 7, 2007 Form 8-K filed with the SEC, New Century stated after revealing the repurchase reserve accounting errors:

> The registrant is evaluating the impact of this matter on its internal control over financial reporting and disclosure controls and procedures for the applicable periods. The registrant expects to conclude that the errors leading to these restatements constitute material weaknesses in its internal control over financial reporting for the year ended December 31, 2006.

Because of this statement by the Company, the Examiner believed it appropriate to perform at least a cursory review of New Century's disclosure controls and procedures, and the implementation of those controls and procedures. This section of the Final Report discusses the Examiner's findings and conclusions with regard to New Century's disclosure controls and procedures. It also describes New Century's processes for drafting earning releases and discusses particular problematic disclosures that were identified.

New Century did not have formal structures or processes that were designed to elicit potential disclosure issues from various parts of the organization for consideration by the Disclosure Committee. Rather, New Century relied on members of the Disclosure Committee to identify issues within their areas of responsibility. Without such formalized processes, there was an increased risk that important questions would not be brought up for discussion. This may have contributed to the fact that in July 2006, only days before the Disclosure Committee met on July 31, Accounting Department personnel determined to change the Company's longstanding practice of marking repurchased loans to their estimated fair market value, and the issue does not appear to have been discussed by the Disclosure Committee. As discussed in this Final Report, this change in accounting methodology resulted in an overstatement of New Century's assets at June 30, 2006 by $81.8 million.

In addition, while the Examiner did not review and analyze all of New Century's statements in public filings and press releases, he identified several problematic statements in connection with his analysis of other accounting and financial reporting issues. Certain of those mistakes are identified in the discussion that follows. Given these errors, there may very well be other misstatements, omissions or inaccuracies in New Century's public filings and press releases.

B. New Century's Disclosure Controls and Procedures

1. Background: The Requirement to Maintain Disclosure Controls and Procedures

Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934 (promulgated pursuant to Section 302 of SOX) generally require SEC reporting companies to maintain "disclosure controls and procedures," defined as "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files ... is recorded, processed, summarized, and reported, within the time periods specified in the Commission's rules and forms." Disclosure controls and procedures include controls and procedures "designed to ensure that information required to be disclosed ... is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers ... as appropriate to allow timely decisions regarding required disclosure."[586]

Exchange Act Rules 13a-14 and 15d-14 require principal executive officers and principal financial officers of reporting companies to certify in Form 10-K and Form 10-Q filings, among other things, (1) that they have designed, or caused to be designed, disclosure controls and procedures to ensure that material information is made known to them by others within the issuer, and (2) that they have evaluated the effectiveness of the issuer's disclosure controls and procedures and presented their conclusions regarding such effectiveness as of the end of the reporting period.

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[586] There is substantial overlap between disclosure controls and procedures and internal controls over financial reporting. In particular, disclosure controls and procedures include those components of internal controls over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. *Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* Securities Act Release No. 33-8238 (June 5, 2003). This section of the Examiner's Final Report discusses New Century's disclosure controls and procedures other than internal controls over financial reporting. Internal controls are discussed in Section __ of in this Final Report..

The SEC does not require that issuers adopt any particular types of disclosure controls and procedures. The only guidance the SEC has issued is the recommendation that issuers form a disclosure committee.[587] Further, secondary sources generally agree that there is no "one size fits all" standard for disclosure controls and procedures. The nature of the issuer's business, operations, and management structure are all factors that will determine what types of disclosure controls and procedures are appropriate for any particular company.

2. Deficiencies in New Century's Disclosure Controls and Procedures

Beginning with the third quarter of 2004, New Century's Form 10-Q and Form 10-K filings included the required officer certifications regarding disclosure controls and procedures, as well as a representation that the responsible officers had evaluated New Century's disclosure controls and procedures and found them to be "effective." These representations were premised on a quarterly review of the Company's disclosure controls and procedures undertaken by New Century's Disclosure Committee.[588]

However, at a meeting held on February 22, 2007, the Disclosure Committee concluded for the first time that New Century's disclosure controls and procedures were not effective for the period ending December 31, 2006. The reason for this determination was the material weaknesses in internal control over financial reporting that prompted the need for the February 7, 2007 restatement announcement. The material weaknesses identified were: (1) the failure to maintain effective controls over the interpretation and application of the accounting literature relating to the Company's critical accounting policies (specifically as to the calculation of repurchase reserves); and (2) the failure to maintain effective controls to provide reasonable assurances that the Company collected, analyzed, and used information relating to outstanding repurchase claims when establishing the allowance for repurchase losses.

New Century maintained some of the types of disclosure controls and procedures that have become common for issuers in response to SOX and SEC rules. These included (1) a

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[587] "[W]e are not requiring any particular procedures for conducting the required review and evaluation. Instead, we expect each issuer to develop a process that is consistent with its business and internal management and supervisory practices. We do recommend, however, that, if it has not already done so, an issuer create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. ... [S]uch a committee would report to senior management, including the principal executive and financial officers, who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the issuer's Disclosure controls and procedures." *Certification of Disclosure in Companies' Quarterly and Annual Reports,* Securities Act Release No. 33-8124 (Aug. 28, 2002).

[588] The members of the Disclosure Committee included many members of Senior Management.

Disclosure Committee, (2) a requirement that certain senior officers execute "mini-certifications" to support the required certifications of the principal executive and principal financial officers, and (3) the use of written Time and Responsibility Schedules ("T&R Schedules") in connection with the preparation of quarterly SEC filings and earnings releases.

The Disclosure Committee had a broad mandate to gather information that could potentially require disclosure, including financial, business, and legal information; to examine the information collected to determine what disclosures were required; to prepare the disclosure reports in draft form; to cause the draft disclosure reports to be reviewed by outside auditors and attorneys, when appropriate; to make certain that the information was accurate; and to formally report the state of the Company's disclosures controls and procedures during the reporting period to the Chairman, President and CEO and CFO. The Disclosure Committee met quarterly in connection with the filing of the Company's Forms 10-Q and the 10-K.

Mini-certifications were signed each quarter by more than a dozen officers at the Vice President level and above to support the certifications of the principal executive and principal financial officers required under Section 302 of SOX. Mini-certifications were tailored to each individual's areas of substantive responsibility, but generally included language stating that the certifier was not aware of any material misstatements or omissions in the filing and had disclosed to the CEO and CFO any deficiencies or material weaknesses in the Company's internal control over financial reporting. T&R Schedules set forth the deadlines for preparing various drafts of filings and earnings releases, and the persons responsible for drafting and review. These included KPMG and the Company's outside counsel, OMM. A "First Working Group" prepared several drafts of the Form 10-Q and Form 10-K filings, the quarterly earnings releases, and the investor conference call slide presentations before elevating them to the "Second Working Group" (comprised of Disclosure Committee members plus the First Working Group), which also went through a number of drafts.

Notwithstanding the presence of the Disclosure Committee, mini-certifications, and T&R Schedules, the Examiner finds that there were deficiencies in New Century's disclosure controls and procedures. For example, New Century did not maintain a comprehensive written set of disclosure controls and procedures that documented the entire process and the responsibilities at each step by various groups and individuals. A comprehensive set of written procedures is one

of the tools that some commentators have recommended to help ensure a consistent and reliable disclosure process.

Further, New Century did not have any formal or structured processes for identifying and raising to the Disclosure Committee potential disclosure issues from throughout the Company. Theologides informed the Examiner that mini-certifications were provided by a broad group of personnel who could be expected to have extensive knowledge of their various subject areas. Nonetheless, New Century did not have additional mechanisms such as disclosure questionnaires, meetings with employees at various levels or written reports to the Disclosure Committee by persons with subject matter responsibilities. Without such structured processes, New Century appears principally to have relied on members of the Disclosure Committee themselves to bring potential issues that they were aware of to the attention of the Committee as a whole.

C. The Drafting Process

1. New Century Management

Witnesses and document review confirmed that Forms 10-K and 10-Q and earnings releases underwent multiple drafts and review by a wide range of Management, substantially as reflected on the T&R schedules. Earnings releases were discussed at group working sessions, with the Investor Relations Department responsible for preparing and revising the drafts.

"Messaging" appears to have been a principal focus of Senior Management in crafting earnings releases. Witnesses described the practice of holding an initial meeting to begin discussing the earnings release, shortly after the end of the quarter, at which the financial data were discussed and the message or themes around the numbers developed.

By mid 2006, executives seemed to be concerned with how to offer the market a positive Company message in the wake of negative financial information. For example, in a memorandum to the Board of Directors dated July 19, 2006, Dodge addressed New Century's second quarter earnings, and outlined "Second Quarter Messaging Considerations:"

> Recognizing the irony of strong results but a sizable earnings miss, we should consider ways to make the negative news of an earnings miss as innocuous as possible. A favorable outcome would be analyst notes with neutral to upbeat tones, recognizing that the timing of loan sales is the key driver of the miss and everything else is good news. ... We have asked the Legal Department to consider our ability to:

* Have a pre-conference call, or some other form of communication, with the analysts, drawing their attention to the sales timing as the key difference between consensus and our results

* Do the call earlier to minimize the time that trading occurs without our additional color

* Do the release and call after market closes in the afternoon, eliminating trading before we can provide color.

Similarly, on October 12, 2006, in connection with the anticipated third quarter of 2006 earnings release, Cole wrote to Gotschall:

> As we focus on our investor message for the 3Q call, I have this grave concern we will not give investors encouragement to hold our stock, let alone go out and buy more. Over the years, especially during the tough times, it was usually Ed and Bob that crafted and polished the investor message and marketed our story.

2. Roles of KPMG and Outside Legal Counsel

T&R Schedules and other documents reviewed reflect that KPMG and OMM reviewed multiple drafts of New Century's periodic reports and earnings releases. KPMG and OMM did not attend New Century's drafting sessions for earnings releases, but provided comments on drafts, respectively, to in-house accounting and legal personnel. OMM was heavily involved in discussions concerning what risk factors to include in the Company's filings and in drafting risk factor disclosures.

D. Particular Disclosure Issues

1. New Century's Backlog of Repurchase Claims

As discussed in more detail in Section VI. of this Final Report, by the end of 2005 New Century appears to have had a backlog of approximately $143 million in repurchase claims that had not been taken into account in the Company's repurchase reserve calculation. That repurchase claim backlog grew significantly through the first three quarters of 2006. An internal New Century report dated August 30, 2006 showed a backlog of approximately $170 million in unresolved repurchase claims that were more than two months old at that time, and of those, approximately $75 million were more than six months old. Other internal New Century reports prepared in the fall of 2006 showed the following repurchase backlog amounts at the end of each month from January through September 2006:

2006	Internally Reported Month-end Backlog
January	$209.1
February	$278.3
March	$281.6
April	$243.1
May	$225.8
June	$199.1
July	$212.8
August	$335.2
September	$399.8[589]

The Company's Form 10-K for 2005 and each of its Forms 10-Q for the first three quarters of 2006 reports the following under the heading "Allowance for Repurchase Losses," after describing generally what the allowance for repurchase losses was: "Generally, repurchases are required within 90 days from the date the loans are sold. Occasionally, we may repurchase loans after 90 days have elapsed." (Emphasis added.) There is no mention in these filings of the repurchase backlog. In light of the large, and growing, size of the repurchase backlog during this time period, it was misleading for New Century to report that it "occasionally" repurchased loans "after 90 days [had] elapsed" from the time of the loan sale – without at least also disclosing the existence and amount of the repurchase claims in the backlog that were more than 90 days old.

New Century's disclosure regarding the allowance for repurchase losses in the Form 10-K for 2005 also reports: "As of December 31, 2005 and December 31, 2004, the repurchase allowance totaled $7.0 million and $6.3 million, respectively. Approximately $10.7 billion and $8.3 billion of loans were subject to repurchase, representing loans sold during the fourth quarter of 2005 and the fourth quarter of 2004, respectively." (Emphasis added.) The Form 10-Q filings for the first three quarters of 2006 have similar language that discloses the amount of the repurchase reserve for each period, but the Form 10-Q filings do not include the language about "representing loans sold" during the just-ended quarter.

In light of the repurchase backlog that existed at the end of 2005, it was misleading for New Century to report, as it did in the highlighted language in the paragraph above, that the

[589] The Examiner notes that three internal New Century reports that are dated before the Company's November 9, 2006 filing of its Form 10-Q for the third quarter of 2006 showed that the amount of the repurchase backlog continued to grow extremely rapidly, rising to $545.1 million as of October 26, 2006.

amount of loans subject to repurchase "represent[ed] loans sold" during the just-ended quarter. In fact, New Century's August 2006 internal report regarding the repurchase backlog shows that there were more than $38 million of loans in the backlog that, as of August 2006, were more than 12 months old, meaning that those loans had been sold sometime before August 2005, which was obviously before the start of the fourth quarter of 2005. Thus, the statement in the Form 10-K for 2005 that the loans subject to repurchase atyear-end2005 "represent[ed] loans sold during the fourth quarter of 2005" was neither complete nor accurate.

This inaccurate Form 10-K disclosure is all the more difficult to comprehend in light of the fact that New Century's Form 10-Q for the third quarter of 2005, filed just four months before the Form 10-K for 2005 was filed, contained the following language regarding the amount of the repurchase allowance and what it represented: "As of September 30, 2005 and December 31, 2004, the repurchase allowance totaled $5.9 million and $6.3 million, respectively, and approximately $10.0 billion and $8.3 billion of loans, respectively, were subject to repurchase, generally representing loans sold during the prior quarter." The use of "generally" in this disclosure, a word that was not used in this part of the Form 10-K for 2005, arguably makes this a more accurate disclosure in light of the repurchase backlog, even though it cannot be said to enhance the disclosure of information about the backlog. It is not clear why New Century did not continue with the use of "generally" in this part of the repurchase allowance disclosure in its Form 10-K for 2005.[590]

In summary, New Century's failure to disclose the existence and amount of the repurchase backlog through the third quarter of 2006 is troubling. The Examiner believes that the existence and amount of the backlog during this time period was information that was necessary to make the information that was disclosed about the allowance for repurchase losses not misleading.

2. September 8, 2006 Press Release Regarding Loan Production

On September 8, 2006, New Century issued a press release announcing August loan production volume. The release included the following quote attributed to Morrice:

> We believe our strict underwriting guidelines, skilled risk management and servicing teams and enhanced fraud detection tools have resulted in lower early payment default and repurchase rates than many of our peers. While we have seen

[590] The use of "generally" in the Form 10-Q for the third quarter of 2005 may also indicate that New Century was aware at that time of the existence of a repurchase claim backlog.

an increase in early payment defaults from 2005 levels as a result of the macro-economic environment, the *increase has been modest.* (emphasis added)

Prior to the date of this release, at 8:50 p.m. on September 7, Cloyd reported in an e-mail to Morrice and Dodge that "we got our teeth kicked in with regard to repurchase requests in Aug. and thus far in September."[591] Morrice responded at 9:56 p.m.: "How can we find out about this just hours after we send a positive press release about this and after sending a positive report to the Board?" Cloyd's e-mail attached a Repurchase Claims Summary spreadsheet that showed 656 repurchase claims resulting from early payment defaults filed in August and the first week of September 2006 on loans totaling $130.8 million, compared with just 285 claims filed during all of 2005 on loans totaling $22.2 million. Although the September 8 press release was likely transmitted outside New Century for purposes of distribution to the public prior to the time that Cloyd sent his e-mail to Morrice and Dodge, the announcement could have been retrieved before it was released. However, no one at New Century took any steps to do so.

In any event, the increase in EPD was hardly "modest." In all of 2005, EPD had ranged from a low of 4.47% in March to a high of 9.24% in December. By contrast, in January through August 2006, EPD ranged from a low of 7.76% in March to a high of 13.42% in August, with July EPD rates being 12.85%. Accordingly, the statement in the press release that the rise in EPD had been modest was utterly without basis.

The Examiner observes that this faulty disclosure relating to the quality of New Century's loans is similar to other questionable loan quality disclosures in New Century's periodic SEC filings. For example, New Century represented in its Forms 10-K for 2004 and 2005 that regardless of document type, New Century designed its underwriting standards and quality assurance standards to make sure that loan quality was consistent and met its guidelines, even when New Century originated stated document loans as opposed to full document loans. This statement is not supportable. First, as noted previously, New Century's Quality Assurance program was not held in high esteem until it was reconstituted and the program was outsourced in September 2005 for nine months. Any suggestion of reliance on the New Century Quality Assurance program is questionable. More important, in October 2004, a New Century employee who regularly compiled statistics on the performance of New Century products stated: "We know that Stated Income loans do not perform as well as Full Doc loans." Then, in early 2006,

[591] All times are Pacific time.

this same employee prepared for Management a document entitled 2005 Delinquencies, which set forth in detail the many ways in which stated document loans performed far worse than full document loans. In the summary of the document, he stated:

> Stated Income loans perform worse than Full Doc loans
>
> . . .
>
> Stated Income\80/20 loans with one borrower have terrible performance relative to other loans in the same FICO band.

There appears, therefore, to be no justifiable basis for the statement in the Form 10-K for 2004.

Similarly, in the Form 10-K for 2005, the following statements appear:

> "Our loan origination standards and procedures are designed to produce high quality loans."[592]
>
> "We adhere to high origination standards in order to sell our loan products in the secondary mortgage market."[593]

The Examiner questions these assertions, which together suggest that New Century in 2005 originated high quality loans. In fact, as previously set forth in Section V. of this Final Report, New Century did not produce "high quality" loans or have "high origination standards."

3. Combination of Allowance for Loan Losses and Valuation Allowance on Real Estate Owned in the 2006 Third Quarter Earnings Release

New Century's earnings release for the third quarter of 2006 reported that at September 30, "the allowance for losses on mortgage loans held for investment and real estate owned was $239.4 million," representing 1.68% of the unpaid principal balance of the loan portfolio. This was the first time the Company had combined the loan loss allowance and the real estate valuation allowance in its earnings presentation. Previous earnings releases had described only the loan loss allowance. Thus, for example, the second quarter 2006 earnings release reported that the allowance for losses on loans held for investment was $209.9 million (1.31% of the portfolio). In the third quarter, the loan loss allowance by itself declined to $1.96 million (1.36% of the portfolio), but combining that figure with the valuation allowance for real estate owned had the effect of showing a larger number -- $239.4 million. Notwithstanding the presentation in

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[592] Form 10-K for 2005 at 8.

[593] *Id.* at 21.

the earnings release, the loan loss allowance and the real estate valuation allowance were broken out and reported separately in the Form 10-Q for the third quarter of 2006.

Dodge determined to combine the two figures in the third quarter earnings release. Dodge told the Examiner that her intent was to provide the investment community with a more complete picture of the company's reserves. She explained that when mortgages defaulted and property was foreclosed upon, the loan loss reserve was charged, and the asset was reclassified as real estate owned, with a separate real estate valuation allowance established.[594] Thus, although the Company's loan loss reserve by itself declined when there was a default, the allowance for real estate owned increased. Dodge related that she believed it was more accurate to report the two reserves together so that investors could see the cumulative change. However, on the third quarter conference call, in response to a question from an analyst about New Century's "margin of safety" on loss expectations, Dodge specifically referenced the $240 million figure as the "allowance for loan losses."

Both Kenneally and KPMG told Dodge that combining the two numbers violated GAAP. This explains why the Company's Form 10-Q for the third quarter of 2006, unlike the earnings release, reported the loan loss allowance and the real estate valuation allowance separately. However, Dodge advised the Examiner that the earnings release was vetted with KPMG, and that KPMG understood the Company's reasons for combining the loan loss reserve and the real estate valuation allowance in the release. The documents produced to the Examiner reflect that KPMG was closely involved in reviewing drafts of the third quarter earnings release. Multiple drafts were sent to KPMG, and on some drafts handwritten notes indicate that KPMG specifically reviewed the portions of the drafts (text and/or table and footnote) that relate to this issue.

4. Mortgage Servicing Rights

As noted in Section VI., New Century made at least two mistakes in its accounting for MSRs. In addition to the accounting deficiencies, the Company also inaccurately disclosed in its financial statements its initial computation of fair value of its MSRs, its amortization methodology and its impairment review. The MSRs disclosures suggested that the accounting was in compliance with GAAP when that was not true. Both New Century and the KPMG

[594] Real estate acquired through foreclosure was recorded at the lower of cost or estimated fair value, net of an allowance for estimated selling costs.

engagement team knew that the Company's accounting practices for MSRs were different than those disclosed in public filings.

X. AUDIT COMMITTEE AND THE INTERNAL AUDIT DEPARTMENT

A. Introduction

The Audit Committee of the Board of Directors plays a critical role in the governance of any public company. The Audit Committee should be comprised of independent Board members (some of whom have financial expertise), should retain independent auditors and should work with both the independent auditors and the Internal Audit Department to monitor a company's financial statements, accounting systems, financial projections, financial disclosures, risks and systems of internal controls. In other words, the Audit Committee should act as an independent bulwark on behalf of shareholders.

From May 2005 through February 2007, the New Century Audit Committee ("Audit Committee") was comprised of four independent Directors: Michael Sachs, Richard Zona, Marilyn Alexander and Donald Lange, with Sachs serving as chair of the Audit Committee. In addition, two other independent Directors played a key role in the activities of the New Century Board of Directors ("Board"): Fredric Forster served as the lead independent Director and David Einhorn was an independent Director who was active on the Board of Directors and the Finance Committee once he joined the Board in spring 2006.

The Examiner acknowledges that the independent Directors of the Audit Committee were capable individuals who approached their role with a sense of responsibility. The Audit Committee also turned to others for assistance, including KMPG for financial issues and the Internal Audit Department for operational issues. The Examiner also acknowledges that the Audit Committee worked within the context of decisions made by New Century's Board. Moreover, beginning in 2006, the efforts of the Audit Committee were augmented by the activities of the Finance Committee, a committee of the Board which was established to focus on the Company's financial forecasting and the format of internal financial reporting. Sachs, Zona, Einhorn and Alexander were members of the Finance Committee.

Fundamental to effective action by any Audit Committee is a monitoring process whereby operational and financial issues are discovered, analyzed and addressed, and remedial policies or procedures are implemented to ensure that financial and operational failures are prevented, or do not reoccur. The Internal Audit Department of New Century ("Internal Audit") was relied upon by the Audit Committee as a key component in gathering information about New Century operations, as well as identifying and analyzing certain areas of operational risk

within the Company. In particular, Internal Audit was to operate pursuant to internal audit "best practices," as set forth in New Century's Charter for Internal Audit, dated September 20, 2005.[595]

The Audit Committee was active from May 2005 to the close of 2006. During this time, the Audit Committee met 21 times, either in person or by telephone. Moreover, the Audit Committee undertook significant activities in analyzing the ramifications of strategic decisions, the structure of management, reviewing financial reports, loan quality issues, and addressing other operational concerns. Nevertheless, the Examiner finds that the Audit Committee was deficient in at least the following areas:

1. The Audit Committee did not ensure that Management conducted an adequate analysis of entity-wide risk;

2. The Audit Committee did not ensure that key operational risks were addressed;

3. The Audit Committee did not give sustained attention to loan quality until 2006; and

4. The Audit Committee did not adequately supervise or make effective use of Internal Audit.

Internal Audit was led by Zalle, a well-qualified Internal Audit professional. Zalle hired qualified staff, and the personnel of Internal Audit seemed to pursue their responsibilities diligently and professionally. Moreover, consistent with sound practices, Internal Audit reported to the Audit Committee, developed a risk-based ranking of issues, typically provided written audit reports to the Audit Committee and developed a procedure to monitor recommendations for improvements. Internal Audit made valuable contributions to the governance and operations of New Century by preparing a significant number of audit reports, and in the process, identified issues concerning loan quality, regulatory compliance, loan servicing and loan appraisals. Nevertheless, the Examiner also finds at least the following significant deficiencies with Internal Audit:

- Internal Audit did not perform a thorough assessment of entity-wide risk;
- Internal Audit did not identify and examine certain areas of operational risk; and
- Internal Audit did not address internal control over financial reporting risk.

[595] The September 2005 Charter specifically states that the Director of Internal Audit is to "apply 'best practice' audit techniques required to accomplish audit objectives."

B. The Role of the Audit Committee and Internal Audit

1. The Role of the Audit Committee

Under best practices for corporate governance, all public companies must have an audit committee, or the entire Board will be deemed to function as the committee.[596] In addition, the NYSE requires every listed company to establish and maintain "an audit committee that satisfies" the statutory standards relating to audit committees, as outlined in 15 U.S.C. § 78j-1(m).[597] In terms of structure, each audit committee member must be independent, which means that the member may not receive fees from the company for any consulting, advisory or other services, and may not be affiliated with either the company or its subsidiaries in any capacity other than as a director.[598] As a matter of best practices, an audit committee should be responsible for:

- The appointment, compensation and oversight of auditors, including resolution of any disagreements between management and the auditors;
- The establishment of procedures for receiving and addressing complaints, including anonymous submissions, concerning accounting, internal control, or auditing matters;
- Developing and supervising an internal audit function; and
- Engaging independent counsel or other advisors. [599]

These undertakings provide the structure for the substantive duties within the purview of the audit committee.

The audit committee has a broad range of duties, including financial analysis, review of financial reports, and ensuring that a company's risks are adequately addressed by company management. Indeed, under the broad topic of risk assessment and risk management, the audit

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[596] *See* 17 C.F.R. § 229.304(a)(1)(iii) (2005); *see also Principles of Corporate Governance: Analysis and Recommendations*, Part III, § 3.05 (A.L.I. 2005); Business Roundtable, *Principles of Corporate Governance* at 17-20 (Nov. 2005).

[597] N.Y.S.E. Listed Company Manual § 303A.06.

[598] *See* 15 U.S.C. § 78j-1(m)(3) (2006); *see also* N.Y.S.E. Listed Company Manual § 303A.07; *Principles of Corporate Governance: Analysis and Recommendations*, Part III, § 3.05 (A.L.I. 2005).

[599] *See* 15 U.S.C. § 78j-l(m). *See also* 17 C.F.R. § 240.10A-3(b)(2)-(5) (2006); N.Y.S.E. Listed Company Manual § 303A.07(c)(iii) & (d); *Corporate Governance: Law and Practice* § 9.04 (MB 2007); Business Roundtable, *Principles of Corporate Governance* at 17-20 (Nov. 2005).

committee should address internal control assessment, external auditor oversight, the effective use of internal auditing, and financial accuracy.[600]

a. The Audit Committee and Risk Management

Risk to an enterprise can exist in many circumstances and is not just inherent in financial reports, operational activities and regulatory compliance. Risk lies in each of these areas, but risk can lie outside such traditional categories, such as where operational components intersect. For New Century, such risks were most noteworthy in the increasingly high risk loan products that New Century originated, as reported on in Section V. of this Final Report. As a result, best practices for corporate governance dictate that the audit committee guide an entity-wide risk management process.

Senior management should assess and manage a company's exposure to risk, but as a best practice, the audit committee should develop guidelines and policies to govern and monitor the process by which risk is addressed and managed. For example, the audit committee should discuss a company's major risk exposures and the steps management has taken to monitor and control such exposures. [601] Moreover, under the supervision of the audit committee, internal audit should provide assurance to the audit committee as to the effectiveness of a company's entity-wide risk management program.

b. The Audit Committee and the Financial Reporting Process

One of the audit committee's primary responsibilities is to monitor and oversee a company's financial reporting process. As part of this oversight, the audit committee must review and discuss with management and the external auditor the company's annual and quarterly financial statements, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."[602] In addition, the audit committee is required to review, prior to issuance, the company's earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies.[603]

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[600] *See* N.Y.S.E. Listed Company Manual § 303A.07(c)(iii) & (d); *see also* Business Roundtable, *Principles of Corporate Governance* 17-20 (Nov. 2005).

[601] *See* N.Y.S.E. Listed Company Manual § 303A.07(c)(iii)(D); Business Roundtable, *Principles of Corporate Governance* 17-20 (Nov. 2005; *Corporate Governance: Law And Practice* § 9.04 (2)(i)(iii)(MB 2007).

[602] N.Y.S.E. Listed Company Manual § 303A.07(c)(iii)(B).

[603] N.Y.S.E. Listed Company Manual § 303A.07(c)(iii)(C) and N.Y.S.E. commentary thereon.

As part of its review of the company's financial statements and earnings releases, the audit committee is required to review and assess the company's critical accounting policies, the quality of accounting judgments and estimates made by management, and any material communications between the external auditor and management.[604] In other words, the audit committee is required to go beyond a simple cursory review of the financial information and actually delve into the background documentation and decisions that led to the financial amounts being reported.[605] The external auditor should provide the audit committee with a report about the accounting principles used and the effects of any alternative accounting treatments discussed with management.

c. The Audit Committee and Control Assessment

The audit committee must have an understanding of management's process for assessing internal controls, applicable regulatory controls, and the risks faced by the organization. A process should be in place for assessing and reporting on financial controls, and the controls in place throughout the enterprise. As part of this process, there should be discussions on control impacts, oversight monitoring,review of the external auditor's audit assessment plan and its opinions, and review of the controls in place for fraud identification.[606]

d. The Audit Committee and SOX

Pursuant to Section 404 of SOX ("SOX 404") and the related SEC regulations, a company must include in its annual report filed with the SEC an internal control report that (1) states management is responsible for "establishing and maintaining an adequate internal control structure and procedures for financial reporting" and (2) contains an assessment of the effectiveness of the internal control structure and procedures for financial reporting.[607] In

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[604] See 17 C.F.R. § 210.2-07 (2006); *see also* Statement on Auditing Standards No. 61, *Communications with Audit Committees*, ("SAS 61"), as amended. SAS 61 requires external auditors to communicate certain matters to the audit committee, including: (1) methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is no authoritative guidance or consensus; (2) judgments and estimates that affect the financial statements, including the process used by management in formulating its accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; (3) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements; and (4) serious difficulties encountered by the auditors in dealing with management related to the performance of the audit.

[605] See 17 C.F.R. § 210.2-07(a) (2006); *see also* N.Y.S.E. Listed Manual § 303A.07(c)(iii)(H) and the N.Y.S.E. commentary thereon.

[606] *See* Business Roundtable, *Principles of Corporate Governance* 17-20 (Nov. 2005).

[607] 15 U.S.C. § 7262(a) (2006).

addition, an external auditing firm that prepares or issues the audit report for the company must "attest to, and report on, the assessment made by the management" for the company.[608]

Neither the statute nor the regulations specifically assign any role to the audit committee in connection with the SOX 404 annual internal control assessment and attestation. However, the SEC, in adopting its regulations, stated that "[t]he preparation of the management report on internal control over financial reporting will likely involve multiple parties, including senior management, internal auditors, in-house counsel, outside counsel, and audit committee members."[609] Accordingly, given the audit committee's oversight responsibilities regarding a company's internal control structure, the audit committee should take "a significant interest in reviewing the annual Section 404 management internal control assessment, the auditor's attestation, and the process by which both were arrived at."[610] This review should include presentations by management and the external auditor at audit committee meetings regarding the SOX 404 internal control report and attestation.[611]

2. The Role of Internal Audit

Although federal statutes do not specifically require companies to maintain an internal audit function, the NYSE requires each listed company to maintain an internal audit function to provide management and the audit committee ongoing assessments of the company's risk management process and system of internal control.[612] Moreover, recognized best practices for corporate governance provide that the establishment of an internal audit function is a key element to an effective internal control system.[613] In particular, the internal audit function

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[608] 15 U.S.C. § 7262(b) (2006).

[609] SEC Release Nos. 33-8238, 34-47986, "Management Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" § V(B) (June 5, 2003).

[610] *Corporate Governance: Law and Practice* § 9.04 (2)(v) (MB 2007).

[611] *Id.*

[612] N.Y.S.E. Listed Company Manual § 303A.07(d) and N.Y.S.E. commentary thereon.

[613] In 1987, the widely circulated "Treadway Report" addressed responsibility with respect to a company's operational activity and financial statements. *See Report of the National Commission on Fraudulent Financial Reporting* (Oct. 1, 1987) ("Treadway Report"). As noted in the Treadway Report, internal audit has a critical role with respect to the financial and operating environment:

> One key practice [to reduce the incidence of fraudulent financial reporting] is the board of director's establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process. Another is establishing and maintaining an internal audit function.

Id. (emphasis supplied).

provides assurance to the audit committee that the internal controls in place are sufficient to mitigate the risks, the governance processes are adequate and organizational objectives are met.[614] The audit committee and internal audit are interdependent, with internal audit providing objective opinions, information, support and education to the audit committee, and the audit committee providing validation and oversight to internal audit.

Internal audit's primary role is to evaluate and report on the effectiveness of the company's risk management, control, and governance processes.[615] To accomplish this primary role, the internal audit department should identify and evaluate the company's "significant exposures to risk and contribut[e] to the improvement of risk management and control systems."[616] This means that internal audit should "evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:

- Reliability and integrity of financial and operational information;
- Effectiveness and efficiency of operations;
- Safeguarding of assets; [and]
- Compliance with laws, regulations, and contracts."[617]

Furthermore, internal audit should continually evaluate "the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems."[618]

a. Internal Audit and Risk Assessment

Best internal audit practices require that internal audit evaluate the risk exposures relating to an organization's governance, operations and information systems, specifically addressing the reliability and integrity of financial and operational information and the effectiveness and efficiency of operations.[619] In 2004, the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") published the *Enterprise Risk Management – Integrated Framework* ("ERM Framework") to assist companies to effectively identify, assess, and manage

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[614] *See generally*, N.Y.S.E. Listed Company Manual § 303A.07(d) and N.Y.S.E. commentary thereon.

[615] *See* N.Y.S.E. Listed Company Manual § 303A.07(d) and N.Y.S.E. commentary thereon; *see also* The Institute of Internal Auditors, *Standards for the Professional Practice of Internal Auditing* 2100 (hereinafter "IIA Professional Standards").

[616] IIA Professional Standards 2110.

[617] IIA Professional Standards 2110.A2.

[618] IIA Professional Standards 2120.A1.

[619] IIA Professional Standards 2110.A1-A2.

a company's risk.[620] COSO defines the ERM Framework 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 risks to be within its risk appetite, [and]... provide reasonable assurance regarding the achievement of entity objectives."[621]

In conjunction with COSO's ERM Framework, IIA has published guidance for internal auditors regarding the role of internal auditing under the ERM Framework.[622] IIA provides that internal audit's "core role with regard to ERM is to provide objective assurance to the board on the effectiveness of an organization's ERM activities to help ensure key business risks are being managed appropriately and that the system of internal control is operating effectively."[623] According to IIA, the core internal auditing roles in regard to ERM are:

- Giving assurance on risk management processes;
- Giving assurance that risks are correctly evaluated;
- Evaluating risk management processes;
- Evaluating the reporting of key risks; and
- Reviewing the management of key risks.[624]

In fulfilling its ERM role, the internal audit analysis of risk must be rigorous and thorough, including risk analysis, risk ranking, and risk investigation. The IIA Professional Standards provide mandatory guidance related to internal audit's role with regard to the risk assessment, requiring that "the internal audit activity's plan ... should be based on a risk assessment, undertaken at least annually."[625] Furthermore, the development of the plan must be followed by independent audits that are presented to the audit committee, with provisions for monitoring and remediation of deficiencies, if necessary.[626]

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[620] *See* COSO, *Enterprise Risk Management – Integrated Framework, Executive Summary* (September 2004).

[621] *Id.* at p. 2.

[622] IIA, *The Role of Internal Auditing in Enterprise-Wide Risk Management,* (September 29, 2004).

[623] *Id.*

[624] *Id.*

[625] IIA Professional Standards 2010.A1.

[626] IIA Professional Standards 2010-2110 *Corporate Gtovernance: Law And Practice* § 14.03 (MB 2007).

b. Internal Audit Role in Financial Auditing

The internal audit role in assessing risk is not just limited to operational or regulatory risk. The internal audit function also has a specific role in auditing financial processes and financial reporting. For example, the IIA Professional Standards specifically provide that the internal audit department should evaluate the risk exposures related to the "reliability and integrity of financial and operational information."[627] Moreover, the IIA Professional Standards provide that the internal audit department also should evaluate the "adequacy and effectiveness of controls," including an appropriate review related to the "reliability and integrity of financial and operational information."[628] The review of the financial information by internal audit often includes "reviewing the financial statements for errors, misstatements, and potential fraud."[629]

3. Audit Committee Oversight of Internal Audit

Because internal audit reports to the audit committee, and because internal audit is critical to the ability of the audit committee to fulfill its responsibilities, the audit committee must closely supervise internal audit. Recognizing this need, the IIA has offered the following guidance on the reporting relationship between internal audit and the audit committee:

1. Role and responsibility [of internal audit] should be defined in a charter approved by the audit committee;

2. The Chief Audit Executive ("CAE") is selected by the audit committee;

3. The CAE should meet regularly with the audit committee and obtain approval for audit plans and budget from the committee or other governing body;

4. The CAE should report functionally to the audit committee and administratively to the CEO; and

5. The CAE should communicate with external audit regularly.[630]

This means that the audit committee must evaluate internal audit and ensure that internal audit is fully identifying risk, fully investigating risk and clearly communicating its findings.[631]

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[627] IIA Professional Standards 2110.A2.

[628] IIA Professional Standards 2120.A1.

[629] *Corporate Governance: Law and Practice* § 14.03 (MB 2007).

[630] IIA Practice Advisory 1110-2: Chief Audit Executive Reporting Lines, and Practice Advisory 2060-2: Relationship with the Audit Committee.

[631] *See generally*, N.Y.S.E. Listed Company Manual § 303A.07.

C. The Charters of the New Century Audit Committee and Internal Audit

Both the Audit Committee and the Internal Audit Department of New Century had charters that generally reflected best practices.

1. The Audit Committee Charter

The Audit Committee Charter ("Committee Charter") for New Century instructed the Audit Committee to assist the Board in:

- oversight of: (i) the accounting and financial reporting processes of the Company and audits of its financial statements, including the integrity of the Company's financial statements, financial reporting process and systems of internal controls; (ii) compliance with the Company's policies and procedures and with legal and regulatory requirements applicable to the Company; (iii) the outside auditor's qualifications and independence; and (iv) the performance of the Company's internal audit function and outside auditors;
- providing an avenue of communications among the outside auditor, Management, the Internal Auditing Department and the Board;
- reviewing areas of potential significant financial risk to the Company; and
- preparing a report as required by the proxy rules of the SEC to be included in the Company's annual proxy statement.

Pursuant to the Committee Charter, the Audit Committee was also directed to discuss and review the Company's Annual Reports on Form 10-K, the Company's Quarterly Reports on Form 10-Q, the information on earnings press releases and financial information provided to analysts and rating agencies.

The Committee Charter also identified the following specific items that "the Committee shall review":

- (i) major issues regarding accounting principles and financial statement presentations, including any significant changes in the Company's selection or application of accounting principles, and major issues as to the adequacy of the Company's internal controls and any special audit steps adopted in light of material control deficiencies;
- (ii) analyses prepared by management and/or the outside auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; and
- (iii) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the Company.

Moreover, it was recognized that the Audit Committee "shall discuss guidelines and policies of the Company with respect to risk assessment and risk management."

The Audit Committee also had clear responsibilities in connection with Internal Audit reports:

> The Audit Committee is to review significant reports prepared by the internal audit department, together with management's response thereto and follow-up to those reports. In the event that such reports concern any significant exposures, fraud or regulatory noncompliance, this review should include reconsideration of the internal controls that should be strengthened to reduce the risk of a similar event in the future.

Further, the Committee Charter also provided that the Audit Committee shall:

> Instruct the outside auditor to report to the Committee on all critical accounting policies and practices of the Company, all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the outside auditor, and other materials written communications between the outside auditor and management, such as any management letter or schedule of unadjusted differences, and shall discuss the same with the outside auditors and management....

2. The Internal Audit Charter

Until September 2005, Internal Audit was governed by the tacit adoption of a charter that Zalle had used with a company where he was previously employed. The broad role of Internal Audit in addressing risk eventually was memorialized in New Century's Internal Audit Charter ("Internal Audit Charter"), which was developed and approved by the Audit Committee in September 2005. The Internal Audit Charter stated:

> The mission of Corporate Internal Audit is to provide independent, objective assurance and consulting services designed to add value and improve the company's operations. It helps the company accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

To accomplish this mission, Internal Audit's scope of work was "to determine whether the company's risk management, control and governance processes, as designed and represented by management, [were]... adequate and functioning." Moreover, as part of that determination, Internal Audit was to ensure:

- Risks are appropriately identified and managed;
- Interaction with internal governance groups as well as the Governance and Audit Committees of the Board, occurs as needed;
- Significant financial, managerial, and operating information is accurate, reliable and timely;

- Quality and continuous improvements are fostered in the Company's control processes.

Thus, company risk and financial information are specifically placed within the ambit of Internal Audit and its functions, and the Internal Audit Charter stated that "the Internal Auditing Division will meet or exceed the *International Standards for the Professional Practice of Internal Auditing* of the Institute of Internal Auditors."

D. Audit Committee Actions

The Audit Committee clearly appreciated the fact that New Century was in a risky business. The Audit Committee's activities between May 2005 and February 2007 must therefore be reviewed against that backdrop.

1. Audit Committee Awareness of New Century Risks

Members of the Audit Committee were aware of the high risks associated with New Century's business plan as well as the subprime industry as a whole. Based on fluctuations in the financial and housing markets from the Russian credit crisis of 1998 and interest rate increases in 2001, members of the Audit Committee told the Examiner that they knew that external events and interest rate changes could significantly impact New Century's business. New Century's external auditor, KPMG, informed the Audit Committee that KPMG viewed the subprime business as risky and charged New Century higher fees because of this view.

The Audit Committee understood there were many significant risks in the subprime industry, including: (1) credit risk – a risk of loan defaults, foreclosures, etc.; (2) funding risk – a risk that warehouse lenders would not provide funds to New Century to originate new loans; (3) liquidity risk – a risk that New Century would not have sufficient available cash to operate; (4) regulatory risk – the risk that government action could make New Century's business plan moot; (5) predatory lending risk – the risk of government actions or attacks by community action groups against certain lending practices; (6) interest rate risk – the risk that fluctuations in interest rates could compress margins; (7) concentration risk – the risk associated with relying on investment banks for everything, *i.e.* providing funding to originate loans and finding investors to buy loans; and (8) competition risk – the risk of increased competition, which could lower the rates and fees received by New Century, because of the relative ease to enter the subprime business.

The Audit Committee specifically recognized credit risk as a significant risk facing New Century. Moreover, the Audit Committee understood that credit risk impacted many facets of

the Company, for if investment banks perceive that the Company has credit risk that was too high, then warehouse lenders would reduce funding, which would affect the Company's ability to originate new loans. Moreover, the Audit Committee recognized that if credit risk was perceived as too high, investment banks would be hesitant to buy the Company's loans, which could cause the price for whole loans to be reduced and the inventory held for sale to age. Further risks included higher kickouts of loans sought to be sold, repurchase claims of loans sold, and more frequent margin calls on warehouse credit lines. For New Century, credit risk also was imbedded in the portfolio of loans it maintained on its balance sheet, which could result in an increase in loan defaults and foreclosures.

The Audit Committee also recognized that low liquidity was a significant risk, as the Company needed to preserve adequate liquidity and have sound inventory management. Low liquidity put the Company at risk on several fronts, including the risk that the Company would not be able to meet margin calls on warehouse lines, and that the Company would have limited flexibility to buy back stock, hold loans, or take other actions.

Finally, the Audit Committee realized that there was risk to under-reserving as to repurchase reserves and loan loss reserves, and constantly reviewed at Audit Committee meetings all reserves requiring judgment. Audit Committee minutes in 2005-2006 are replete with Audit Committee inquiries as to reserve matters.

2. Audit Committee Oversight of the External Auditor

To fulfill its responsibilities, the Audit Committee monitored the performance of KPMG in several different respects. The Audit Committee invited KPMG to attend and participate in each Audit Committee meeting, and to be present for the entire length of each meeting. Moreover, the Audit Committee received an engagement letter from KPMG that defined the scope of its work. In addition, KPMG would report to the Audit Committee on its annual audit and quarterly reviews of New Century's financials, as well as provide SAS 61 reports.

During the Audit Committee meetings, KPMG routinely would discuss its review of the significant accounting "judgment areas" as part of its report regarding New Century's financials. KPMG's discussion usually focused upon the accounting results in the valuation of residuals and related hedging, allowance for loan losses, repurchase reserves and taxes. KPMG would typically report that it reviewed these areas and that KPMG believed that the accounts were reasonably stated. KPMG would then respond to questions from the Audit Committee, such as

the degree of conservatism in the calculations. The Audit Committee was active in asking KPMG questions and discussing issues that KPMG might raise.

In exercising its oversight responsibilities, the Audit Committee questioned the decision by KPMG to replace Kinsella with Donovan as the partner in charge of the New Century account in early 2005. Kinsella was well respected by the Audit Committee and was viewed as a valued resource. Donovan, on the other hand, was new to KPMG, and concerns arose within the Audit Committee whether Donovan had a sufficient understanding of the issues facing the subprime industry, and whether he had sufficient stature within KPMG.

Although requested by the Audit Committee, KPMG refused to provide another engagement partner and the Audit Committee briefly considered replacing KPMG in early 2005. Ultimately, the Audit Committee determined that a switch to a new accounting firm would be tremendously disruptive and would send a bad signal to its lenders. Accordingly, KPMG continued to be retained by the Audit Committee.

Another action by KPMG that caused concern within the Audit Committee involved a hedge accounting issue identified by KPMG in March 2006. During its presentation relating to the 2005 audit at the March 2, 2006 Audit Committee meeting, KPMG indicated that concerns had arisen relating to New Century's documentation for its hedge accounting. KPMG stated that if the concerns were not satisfied, New Century would be required to make a large adjustment. Two days after the March 2, 2006 Audit Committee meeting, Management informed the Audit Committee that KPMG had signed off on the hedge accounting issue. Nevertheless, the very day that New Century's Form 10-K was to be filed, the Audit Committee members learned that KPMG thought the hedge accounting documentation was inadequate and would not sign off on New Century's financials. In particular, Management informed the Audit Committee that "an internal disagreement appeared to have arisen within KPMG between one of the review partners and its Department of Professional Practice and the audit review team the evening before [New Century] was required to file its Form 10-K." Later in the day, KPMG finally decided that the documentation was sufficient and New Century's Form 10-K was filed timely.

The hedge accounting issue of March 2006 shook the Audit Committee's confidence in KPMG. As a result, the Audit Committee decided to defer its decision on retaining its 2006 external auditor until a determination was reached that KPMG could properly serve in this role. Eventually, the Audit Committee decided to retain KPMG. The Audit Committee's decision was

made after KPMG conducted an internal review and outlined steps to avoid a similar situation in the future. Moreover, the Audit Committee felt that any change in the external auditor would be extremely disruptive, especially considering the recent move to make Morrice the new CEO and the then on-going search for a new CFO.

3. Audit Committee Review of Accounting Results in Areas Calling for Management Judgment

Consistent with best practices and the requirements of the NYSE Listed Company Manual, the Audit Committee reviewed and assessed New Century's accounting results in areas calling for Management judgment, including: (1) the valuation of residuals and related hedging; (2) allowance for loan losses; (3) repurchase reserves; and (4) taxes. On a regular basis, the Audit Committee would question both Management and KPMG regarding these areas, which are based, in large part, on the judgment of Management and the New Century Accounting staff. These discussions with Management and KPMG took place in 2005 and 2006 at regular Audit Committee meetings and separate executive sessions.

The Audit Committee reliance on KPMG to assist in these accounting areas requiring management judgment is reflected in the KPMG quarterly reviews of New Century's financials and the KPMG SAS 61 reports. KPMG would report that it reviewed these accounting areas and that KPMG believed that the accounts were reasonably stated. Indeed, KPMG never reported any disagreements with the Company's Management as part of its SAS 61 Reports.

The Audit Committee held executive sessions with KPMG that included the following inquiries: (1) did KPMG review the residuals and are they valued correctly; (2) were the reserves, particularly the loan loss and repurchase reserves, reviewed and are they reasonable; (3) did KPMG observe anything that the Audit Committee should be concerned about; and (4) did New Century's personnel cooperate during KPMG's review. The reason for this procedure was because the Audit Committee wanted KPMG's opinion about reserves without Company personnel present; *i.e.*, to be open with the Audit Committee without the Company's influence. To the recollection of the members of the Audit Committee, KPMG never raised any items that required Audit Committee action.

a. Repurchase Reserves

The repurchase reserve was a major issue to the Audit Committee because the level of the repurchase reserve could have a significant impact on earnings. Furthermore, if repurchase reserves were increased, loan buyers might interpret this increase as an indication that the quality

of New Century's loans was poor. Repurchase reserves could also impact lender perceptions as to the Company, and increasing reserves could be a sign of potential underwriting problems to lenders.

The Audit Committee asked KPMG on a quarterly basis whether the Company's repurchase reserves were adequate, and the Audit Committee always received confirmation from KPMG that the reserves were adequate and reasonably stated. The Audit Committee also inquired of Senior Management as to repurchase reserves, but received no indication from either Dodge or Kenneally that there had been a change in the methodology used to calculate the repurchase reserves. Furthermore, all members of the Audit Committee expected KPMG to inform the Audit Committee of any change in the methodology of calculating the reserve. KPMG never disclosed the change in accounting methods related to the calculation of the repurchase reserve to the Audit Committee.

According to the Audit Committee minutes, Kenneally informed the Audit Committee at its January 31, 2007 meeting that Management had reviewed its repurchase reserve methodology, "which had changed in the second quarter of 2006, and had concluded that the Corporation's methodology applied in the second quarter was inappropriate." Members of the Audit Committee informed the Examiner that their reaction was one of shock and dismay. The Audit Committee asked Kenneally why the methodology change was not previously disclosed to the Audit Committee. Kenneally responded that it was an "inadvertent oversight." In response to a question, Kenneally further said that KPMG was aware of the methodology change. According to one Audit Committee member, Kenneally looked directly at Kim, who nodded yes. That same Audit Committee member stated that Donovan also confirmed that KPMG was aware of the change in methodology.

b. Residual Interests

Similar to repurchase reserves, the Company's residual interests also were a consistent topic of discussion at Audit Committee meetings. Residual interests were considered a highly sensitive area because their valuations were subject to judgments by accounting, and the Audit Committee believed KPMG had the responsibility to review and monitor the assumptions underlying the valuation calculations. The Audit Committee would discuss residual interests in depth with the Company's Accounting and Secondary Marketing Departments and KPMG. The

focus of these discussions generally was on the discount rate, the loss assumption and the prepayment assumption.

The Finance Committee, which included three of the four Audit Committee members, also reviewed and assessed the adequacy of the discount rate used in the residual interests valuations. During the October 16, 2006 Finance Committee meeting, there was a discussion regarding a Residual Discount Rate Analysis prepared by Management and reviewed by KPMG. This rate analysis recommended an increase of the discount rate to 15% from 12% (non-NIMS rate) and 14% (NIMS rate). Zona recalled that the Finance Committee discussed the discount rate at length, and the discussion included a reiteration of New Century's residual interest valuation methodology, as well as assurances that the then current discount rates were within GAAP. Contrary to the recommendation of Management, the discount rate was not raised "at that time," and that "for the short-term the corporation would continue to apply" the 12% and 14% discount rates.

Zona stated that there were several reasons for this decision. First, the current rate being used by New Century had been disclosed in New Century's filings with the SEC, including New Century's most recent Form 10-Q. In addition, because the significant majority of the residuals were NIMS, the weighted average rate was very close to 14%. This meant that it would only be an increase in the discount rate of one percent. Zona told the Examiner that if the discount rate was in accordance with GAAP but on the low side of the industry range, changing from 14% to 15% was "a change without substance." Zona further explained that many on the Finance Committee thought that a change from 14% to 15% could be misconstrued by investment banks as "too clever by half," and would be viewed by investors as "sleight of hand" to appear conservative. In addition, some members of the Finance Committee, including Zona, wanted to increase the residual discount rate to 20%, or more, and if New Century was going to change, *i.e.* be more conservative, then New Century should make a meaningful change, and that based on the current analysis as of October 2006, Management was not comfortable changing to 20%. Finally, New Century was hiring a new CFO who might, after analyzing New Century's residual interests, decide a different methodology was appropriate or that the residual discount rate should be changed differently. Accordingly, the Finance Committee decided that the Company should not change the discount rate to 15% or any other number at that time.

Einhorn told the Examiner that in connection with this Finance Committee meeting, he understood the 12% and 14% discount rates to be within GAAP. He also recalls that he did not believe the analysis supporting the change to be adequate, and that he perceived the recommendation was proposed by Management to accommodate KPMG. Einhorn recalls that rather than take this small step, which might be followed by other increases, the Finance Committee wanted a more complete analysis, and based on that analysis, the Finance Committee would raise the discount rate to 20%, or to whatever number that was justified by the analysis.

c. Other Accounting Issues

In October 2005, Management tried to adjust its loan loss reserves. Specifically, the Company experienced a tax problem that resulted in a reduction in earnings of $0.26/share. Dodge presented a report to the Board of Directors showing that earnings would not be reduced because, as Management argued, the Company was over-reserved in its allowance for loan losses by exactly the same $0.26/share. Zona described Management's argument for reducing the loan loss reserves and his opposing argument in his November 1, 2005 draft resignation letter as follows:

> Management attempted to justify the reversal of loan loss reserves by stating that the delinquency and charge off experience for the portfolio was much better than expected. However, management also knew that there will be losses from hurricanes Katrina, Rita and Wilma, but had not quantified the amount of the losses. (Wells Fargo and B of A have provided $100 million and $50 million, respectively, for hurricane losses).

Zona wrote in his November 1, 2005 draft resignation letter that this "smacks of earnings manipulation." Zona made it clear that he would not approve the financial reports if the adjustment to the loan loss reserve was made, and Management ultimately did not make the adjustment.

4. Audit Committee Review of Financial Reports

The Audit Committee reviewed and approved all of the Company's Forms 10-K prior to filing with the SEC. The Audit Committee's approval was in the form of a resolution adopted by the Committee recommending to the Board the inclusion of the audited financial statements in the Company's Form 10-K. The Audit Committee also would approve the Company's Forms 10-Q prior to filing with the SEC. In addition, the Audit Committee reviewed drafts of the Company's earnings releases.

E. Internal Audit Functions

Zalle joined New Century in November 1999 to develop the Internal Audit function at the Company, and remained the head of Internal Audit until he left the Company in July 2007. He reported to the Audit Committee and his performance reviews were conducted by the Chairman of the Audit Committee. At his hiring, Zalle was told that New Century had decided to develop an internal audit group to add "credibility" in order to be traded on the NYSE. He was further told that New Century needed professional risk assessment to identify the highest areas of risk because of the high risks in the subprime business. Zalle was the only member of the Internal Audit Department in late-1999 and early-2000, so he outsourced much of the internal audit functions to KPMG and E&Y for approximately two years. In 2002, Zalle hired George Arambula, first as a consultant from E&Y, and then as a New Century employee. Arambula was knowledgeable in information technology ("IT"), and was responsible for auditing IT and general corporate office audits. Ron Brown was hired to perform field operations audits and a field audit staff was developed to assist Brown.

All three of the Internal Audit leaders were qualified for their positions. Zalle had held various high-level internal audit positions with financial services companies. Arambula had a Bachelor's degree in Accounting and an IT, and prior to joining New Century, had worked for various financial services companies and E&Y's IT consulting practice. Brown had an extensive background in the financial services industry, as well as many years in mortgage banking, including specific experience in underwriting analysis.

1. The Audit Process and Risk Assessment

Zalle started to prepare an audit plan by consulting with Sachs and solicited input from Senior Management as to risk. The discussions with Management as to risk were done at meetings. Zalle did not keep notes or memoranda of the meetings. Once Zalle identified risk-rated areas for audit, he developed audit plans based upon risk level and available resources. Audit plans usually covered a three-year period, and the areas with the highest risk levels were selected for audit in a given year.

After Internal Audit conducted an audit, an audit report was issued explaining the review process, what was found and Internal Audit's opinion as to the adequacy of process controls. The opinion would contain one of the following "bottom-line" conclusions: "satisfactory;" "satisfactory with improvements needed;" "needs improvement;" or "unsatisfactory." Any area

designated "unsatisfactory" or "needs improvement" was identified as high risk for the following year.

When an audit report was issued, copies were typically sent to Management, including the applicable department head responsible for the area being audited, and often to the Audit Committee. Copies also were available to KPMG. If any problems were identified, Management in the audited area would be required to respond within three weeks, and the Management responses would go to Senior Management and the Audit Committee. In the response, Management would have to explain how the problems would be corrected (typically termed "remediation" within the Company), and when the remediation would be completed. Management was responsible for the design and implementation of the remediation and Internal Audit would conduct a follow-up audit to verify that the corrective actions were implemented in a timely and complete manner.

Both Zalle and the Audit Committee viewed financial audits as being outside of the scope of Internal Audit's responsibility. The Audit Committee delegated to KPMG the responsibility for addressing financial risks and conducting financial audits. This contradicted the Internal Audit Charter, which identified examination of "financial" risk as a role of Internal Audit. Zalle stated that although the limitation of Internal Audit to operational areas was not a written policy, there was a broad understanding with the Audit Committee that Internal Audit would not conduct any financial audits.

The areas of risk for Internal Audit review were typically identified by Zalle and reviewed by Sachs, with input from Management and Internal Audit personnel, and approved by the Audit Committee. One example of input from Internal Audit personnel was a January 16, 2004 e-mail from Brown to Zalle in which Brown urged that the level of field audits increase. This request was made because Brown and his team of field auditors were conducting their own file reviews and "walk-throughs" of loans to make sure the Quality Assessment/Quality Control ("QA/QC") controls were satisfactory. During this time, Internal Audit found many exceptions to underwriting standard, and concluded that something was "falling apart" in the QA/QC function. Internal Audit found that loans would get through the QA/QC process, even though the loans had problems with the LTV ratio or the stated income did not look accurate.

In response to the problems discovered by Internal Audit in the QA/QC function, Zalle expanded the scope of the underwriting/loan quality audits in 2005 to include both a compliance

audit and a system of internal control walk-throughs. Zalle designed the 2005 audit program to include the audit of a cross-section sample of eight wholesale processing centers and one retail center. Internal Audit next identified a sample number of loan files per operating center, and then conducted a "walk-through" that involved reviewing the loan origination process from the time the loan first entered the system through loan funding. Internal Audit then conducted testing to ensure that internal controls related to loan applications, such as verifications and exceptions, were handled properly. Internal Audit also looked at underwriting procedures, account manager review/approval, appraisals and funding. The results of the loan quality field audits were dismal. Of the nine branches audited, none were rated satisfactory, seven were rated unsatisfactory and two were rated as needs improvement. This should have been a strong signal to the Audit Committee and Senior Management that significant improvements in loan quality were needed.

Other operational areas of significance did not receive similar attention. For example, Brown also advocated in his January 16, 2004 e-mail that Internal Audit review the Secondary Marketing Department, including "reviewing investor rejects." Investor rejects were called "kickouts" by the due diligence teams, and Zalle acknowledged that a great amount of reliance was placed on investor rejects in addressing loan quality. Zalle also expressed the view that New Century personnel believed that New Century loan quality was good because its kickout rates were reported to be lower than those of competitors. However, Zalle cautioned that these kickout rates did not give a complete picture of loan quality because investors often did not perform extensive due diligence. Although Zalle acknowledged that kickouts provided some sense of loan quality, the area was not the subject of Internal Audit scrutiny. Similarly, the processes of Secondary Marketing with respect to reviewing and processing kickouts and repurchase claims were never audited by Internal Audit.

As part of the risk management effort, E&Y developed an ERM proposed approach for New Century in December 2005 ("ERM Proposed Approach"). The ERM Proposed Approach noted that New Century Senior Management perceived that there were "common gaps in our risk management practices." The ERM Proposed Approach further identified "Liquidity," "Operations/Processes," and "Accounting Policies and Financial Reporting" as risks. E&Y also identified the "Risk of inappropriate processes and controls in the origination (underwriting, funding), secondary, servicing and other operations such as failure to identify, capture, and/or

communicate data in a timely period which does not enable employees to carry out their responsibilities." Zalle conceded to the Examiner that all the areas identified by E&Y were high-risk but Internal Audit never addressed any of them.

2. Audit Committee Supervision

Zalle stated that a quality assurance review of the Internal Audit Department was not conducted during his tenure. In addition, although Zalle received performance reviews from the Chairman of the Audit Committee, the feedback was verbal and vague. Zalle asserted that during his performance evaluations, he was simply told to "keep up the good work" or "you are auditing the right stuff." When asked if written key performance indicators or benchmarks were established to measure his performance, as well as the performance of the Internal Audit Department, Zalle indicated that such benchmarks had not been established. Indeed, both Sachs and Zona conceded to the Examiner that the Audit Committee made no effort to assess whether IIA Professional Standards were met by Internal Audit.

3. SOX

Zalle told the Examiner that Internal Audit had no substantive role in the SOX 404 review because SOX 404 was the responsibility of Management. Zalle stated that Kenneally was the key SOX person and that he brought in E&Y to assist in the SOX 404 review.

Internal Audit's limited role in SOX 404 review was to oversee the timing and implementation of the SOX 404 review and report to the Audit Committee on whether New Century would meet its SOX requirements. Specifically, Internal Audit reviewed the timing and scope of the SOX 404 review to make sure critical control areas were captured within the scope of the review. Internal Audit also monitored whether work was scheduled so that the SOX review could be completed on time.

On a quarterly basis, Zalle signed a certification letter addressed to Cole, Morrice and Dodge listing facts upon which those individuals could rely and determine whether to execute and deliver their SOX 302 certifications. In the certification letter signed by Zalle for the quarter ending September 30, 2006, Zalle certified to the following:

We have disclosed,

> All significant deficiencies and material weaknesses in the design or operation of New Century's internal controls over financial reporting which could adversely affect New Century's ability to record, process, summarize and report financial data; and....

a. During the quarter ended September 30, 2006, there were no changes in New Century's internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, New Century's internal control over financial reports, including any corrective actions with regard to significant deficiencies and material weaknesses.

Zalle stated that in order to certify to these statements, he relied on KPMG and the financial management team to be doing their jobs.

F. Deficiencies in Audit Committee/Internal Audit

Although the Audit Committee addressed issues concerning inventory, liquidity and management structure, the Audit Committee was deficient in not addressing other issues, including entity-wide risk assessment, operational risk, Internal Audit performance and loan quality.

1. Failure to Engage in Entity-Wide Risk Assessment

The Audit Committee and the other independent Directors were active in identifying certain risks, such as credit risk in New Century's loan portfolio and areas of accounting judgment. Nevertheless, the Audit Committee undertook no effort to ensure that Management undertook comprehensive examination of risks to the Company. The Audit Committee admittedly recognized several areas of risk to the Company, including the concentration risk of relying on a limited number of lenders for all financing, operational issues in secondary marketing, and issues concerning underwriting. The Audit Committee also realized the ramifications that these risks posed the Company. For example, if the lenders did not provide funds through warehouse lines of credit, then the Company could not do business. Similarly, if there was no market to sell loans on the secondary market at appropriate prices, then the Company could face serious issues.

The Audit Committee was aware of the need for entity-wide risk assessment and was provided an Enterprise Risk Management Program Description ("ERM Description"). This ERM Program Description identified risks as including "liquidity," "strategic planning and decision making," "capital management," "operations/process," and "accounting policies and financial reporting." Despite this information and the best practices for an audit committee to ensure an entity-wide risk assessment, the Audit Committee did not ensure that any entity-wide risk assessment program was in place. As a consequence, certain significant risks were not analyzed. For example, neither the Audit Committee nor anyone else addressed funding risk,

and as a result, options were not analyzed and contingency plans were not put in place. In addition, operational issues in Secondary Marketing, such as keeping track of the backlog of pending repurchase claims, were never identified.

Internal Audit also had no consistent and documented examination to identify the risks of the Company, and the risks identified in the E&Y ERM Proposed Approach were never analyzed or monitored by Internal Audit. This failure of Internal Audit and the Audit Committee to ensure that there was a program to analyze risk on an entity-wide basis was contradictory to best practices.

2. Failure to Address Key Operational Risks

One of the consequences of the failure to address entity-wide risks was the failure to analyze certain operational risks. Internal Audit analyzed the Company's operations, and based on that review, developed a three-year audit plan. To develop its plan, Internal Audit obtained input from Management and rated several characteristics (*e.g.* critical programs, vital systems and significant operations) to derive an overall risk ranking per audit area. The highest ranked areas were presented to the Audit Committee in the three-year audit plan and it generally was approved without any changes.

As a result of this approach, Internal Audit focused on several key operational areas, including underwriting, appraisal, servicing and regulatory compliance. Nevertheless, some critical areas of operational risk were neither identified nor addressed. Notably absent from this list of audit projects was any audit of the Secondary Marketing Department, including Secondary Marketing organization and operations, the processing of reviewing and addressing repurchase claims, the process for deciding what loans to hold in the portfolio, how inventory was handled and the loan quality in inventory. Other operational areas, such as the process of reviewing and addressing kickouts, were identified, but never addressed.

Secondary Marketing was critical to the Company because it both executed loan sales and selected loans to be kept on New Century's balance sheet. Brown had focused on the need to audit Secondary Marketing and kickouts as early as 2004. Zalle acknowledged to the Examiner that Internal Audit should have addressed the repurchase claim process, as well as other areas of Secondary Marketing, including the amount of investor kickouts. The Examiner never received a satisfactory explanation why this did not occur.

The reason these areas were not identified or analyzed is rooted in process flaws inherent in the Internal Audit function and not addressed by the Audit Committee. Based on the number of audit areas that were given similar risk scores between 90 – 100 and the lack of supporting documentation for the development of risk assessment, the Examiner determined that a robust risk assessment framework was not utilized to develop the Company's internal audit plan. In the 2005 audit plan, 77 auditable areas were identified and 45, or 58%, had a risk score of 90 or more. Zalle said that an annual risk plan was provided to the Audit Committee based on his understanding of the business, interviews with Senior Management and KPMG, results of prior audit reports, and determinations whether specific risks were previously audited.

Internal Audit was not making true distinctions as to risk and was not going beyond operational issues that carried over from prior years. This reflects a flaw in the process, and the fact that this flaw was not addressed by the Audit Committee is a significant deficiency. If the Audit Committee had required an entity-wide risk management approach and had Internal Audit followed such an approach, it is possible that critical operational risks would have been identified and addressed.

3. Failure to Assess Financial Risk

In general, Internal Audit did not conduct any financial risk assessment, or develop an annual financial audit plan. The complete reliance by Internal Audit and the Audit Committee on KPMG to address significant deficiencies and material weaknesses in the design and operation of internal controls over financial reporting did not follow industry best practices and guidelines established by the IIA. This also contradicted the express language of the Internal Audit Charter, which specifically stated that the scope of Internal Audit included determining:

> whether the Company's risk management, control, and governance processes, as designed and represented by management, is adequate and functioning to ensure...significant **financial**, managerial, and operating information is accurate, reliable, and timely.

Zalle stated that although he considered some review of financial processes to be part of the scope of Internal Audit, he placed reliance on KPMG's work to address the accuracy of the financial information. This singular focus of Internal Audit on operational issues conflicted with internal audit best practices and the Audit Charter itself. It also may have prevented tracing the control deficiencies back to the financial statements and/or reduced the urgency of timely remediation. Moreover, it reflected a lack of adequate supervision by the Audit Committee.

Indeed, the fact that Internal Audit was not required to be more proactive in financial auditing is especially surprising in light of the fact that the Audit Committee had concerns about KPMG once Donovan became the engagement partner. There is no guarantee that Internal Audit review of financial processes would have identified the accounting deficiencies identified by the Examiner, but the opportunity never existed under the approach adopted by the Audit Committee of limiting Internal Audit to operational issues.

4. The Failure of the Audit Committee to Supervise or Make Effective Use of Internal Audit

The Examiner found evidence of lax oversight by the Audit Committee of Internal Audit. The Internal Audit Charter specifically stated that Internal Audit must use best practices and will be held to IIA standards. Nevertheless, the Audit Committee did not require accountability. The first indication of lax oversight was the development of the Internal Audit Charter. Prior to September 2005, the Internal Audit Department operated under the guidelines of an internal audit charter from Zalle's previous employer, *i.e.*, a charter from a different company from the 1990s. Once drafted, the New Century Internal Audit Charter was well crafted and encompassed best practices. However, because the Department operated for so long with no clear guidance, poor practices developed, such as limiting Internal Audit to operational areas and total reliance on KPMG for financial audits.

In addition, the Audit Committee did not monitor whether Internal Audit adhered to the Internal Audit Charter. Internal Audit was "to meet or exceed the International Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors," but the Audit Committee admittedly did not examine whether there was adherence to IIA standards. Further, the Audit Committee did not document its evaluation of the performance of the Internal Audit Department or Zalle. In fact, the Audit Committee did not identify specific benchmarks to measure the Internal Audit performance, and Sachs admitted that he did not benchmark Internal Audit against IIA Standards or any other internally-established performance goals.

Another indication of lax oversight was that Internal Audit never undertook an internal quality assurance review. As a result, the Internal Audit Department was in non-compliance with the Internal Audit Charter and the IIA standards. Furthermore, Internal Audit did not establish internal benchmarks and did not communicate with the Audit Committee about these shortcomings. The Audit Committee should have ensured that such performance and quality reviews occurred.

Finally, although the Audit Committee meeting minutes indicate that Internal Audit plans were approved by the Audit Committee, the meeting minutes do not indicate that any detailed discussions took place regarding how the audit plans were developed or how risk areas were identified. Further, no consistent standards or benchmarks were used to:

a. Identify audit areas included in the risk assessment;

b. Assign risk ratings of one through 10 within each of the 10 risk categories; and

c. Identify the audit areas that then would be included in the annual audit plan.

The Audit Committee's failure to systematically supervise Internal Audit meant that there was a gap in identifying the appropriate risks of the Company.

5. Failure to Address Loan Quality Issue

The Audit Committee also contributed to the inattention to loan quality and did not closely oversee the remediation of New Century's poor loan quality. Under best practices for corporate governance, as well as the requirements outlined in the NYSE Listed Company Manual, the Audit Committee was required to discuss the Company's risk assessment guidelines and policies with Management and oversee the process by which risk assessment and remediation were undertaken.[632] With loan quality, however, the Audit Committee downplayed the significance of this risk and did not require Management to implement remediation procedures until 2006. By that time, billions of dollars of suspect loans were on the balance sheet of New Century and sold to investors.

The Audit Committee should have identified and analyzed, along with Management, the material risks facing the Company related to loan quality. In other words, Management, with Audit Committee oversight, should have documented New Century's business objectives and identified the risks that could undermine those objectives, such as the risks related to poor loan quality discussed in Section V. of this Final Report. Internal control processes should have been developed, such as specific policies, procedures and practices, for achieving the business objectives and mitigating risk.

Finally, the Audit Committee should have understood the significant deficiencies and material weaknesses in Management's internal control structure related to loan quality, and held Management accountable for resolving these significant deficiencies and material weaknesses. The Audit Committee identified and recognized the risks to New Century arising from poor loan

[632] N.Y.S.E. Listed Company Manual § 303A.07(c)(i)(ii)(D).

quality. Each of the Audit Committee members interviewed by the Examiner acknowledged that poor loan quality would result in an increase, at a minimum, in repurchase requests and kickouts. Moreover, the Audit Committee understood that an increase in repurchase requests and kickouts would place a strain on New Century's liquidity, resulting in an aging inventory and lower profits.

Although the Audit Committee recognized and appreciated the risks caused by poor loan quality, the Audit Committee did not require Management to establish and maintain an adequate internal control structure to minimize these risks. According to Zona, while loan quality had been an issue for the Company for a long time, there were other items of higher priority for the Board and Audit Committee. The Audit Committee felt that, ultimately, the investors who purchased the loans would provide the appropriate feedback as to whether the performance in loan quality was satisfactory. This was not the proper standard.

In 2005, New Century's loan quality problems became clearly evident as Internal Audit conducted loan quality audits in nine branches. Of the nine branches audited, none were satisfactory: seven were rated "unsatisfactory" and two were rated "needs improvement." The branch audits were presented to the Audit Committee, but the Audit Committee did not seem overly concerned about the problems highlighted by the branch audits. Audit Committee members told the Examiner that the problems were basically "paperwork" errors as opposed to an indication of the severity of loan quality problems.

Even when Management established a remediation plan for loan quality in 2006 at the Audit Committee's direction, the Audit Committee failed to (1) require an expedited time frame to remediate the significant deficiencies identified, (2) ensure that Management prioritized the remediation efforts, and (3) adequately verify that the remediation plans were implemented and operating effectively. The Audit Committee's response was simply to instruct Management that loan quality needed to improve and it should "go fix it," without proper verification or follow-up. These matters are reported on in Section V. of this Final Report and will not be repeated here.

XI. KPMG

A. Introduction

KPMG was the independent auditor for New Century from the Company's founding in 1995 until KPMG resigned in April 2007 soon after the Company filed its Chapter 11 petition. During those 12 years, the engagement was overseen by several different partners with varying degrees of experience in the mortgage banking industry.

In the spring of 2005, a new engagement partner took over the New Century account, and a predominantly new team of auditors was brought on to assist him. The next two years proved to be turbulent. In March 2006, an eleventh hour disagreement among members of the engagement team threatened New Century's ability to timely file its Form 10-K for 2005, caused significant tension between New Century's Audit Committee and KPMG's engagement team, and nearly cost KPMG the engagement for future audit years. In February 2007, New Century announced that it needed to restate its financial statements for the first three quarters of 2006. In April 2007, following New Century's filing of its Chapter 11 petition, KPMG resigned. In May 2007, New Century announced that the Company's audited 2005 financial statements for the year ended December 31, 2005 (hereinafter "2005 year-end financial statements") should no longer be relied upon.

As discussed in Section VII., the Examiner has concluded that the earnings reported in New Century's 2005 year-end financial statements were materially overstated by at least $63.6 million. In addition, New Century's earnings were materially overstated in its interim financial statements for the first three quarters of 2006 by at least $7.4 million, $75.6 million and $116.4 million, respectively.

The Examiner has compiled an extensive record over the course of the investigation (including interviews, workpapers, e-mails, and other documents) relating to KPMG's annual audits and quarterly reviews of New Century's financial statements in an effort to determine the extent, if any, of KPMG's knowledge of, involvement with, and/or responsibility for these material misstatements in New Century's financial statements. In addition, the Examiner has sought to determine whether KPMG, in conducting its audits and reviews of New Century's financial statements, performed its work in accordance with applicable professional standards.

As discussed in greater detail below, the Examiner finds that KPMG did not perform its reviews and audits in accordance with professional standards in at least the following respects:

- Certain factors, including KPMG's staffing of the New Century engagement team and its relationship with the client during the applicable periods, increased the risk that KPMG would not detect a material misstatement in the financial statements.
- KPMG failed to exercise due care by providing erroneous advice to New Century that was inconsistent with GAAP regarding the Company's methodology for calculating repurchase reserves and its methodology for calculating lower of cost or market ("LOCOM") adjustments for repurchased loans, and New Century relied on this advice. In addition, KPMG failed to exhibit the appropriate amount of professional skepticism in reviewing the methodology employed by New Century to calculate its repurchase reserve and ignored critical evidence that indicated the methodology was flawed, which resulted in a material understatement of the reserve and overstatement of the Loans Held For Sale ("LHFS") portfolio.
- KPMG failed to criticize New Century's reliance, through 2006, upon outdated and inadequate internally developed models to value residual interests worth hundreds of millions of dollars, even though KPMG's reviews and audits repeatedly detected flaws in those models. In addition, although KPMG specialists frequently questioned the low discount rates that New Century used in those models (which tended to result in inflated valuations of the Company's residual interests), KPMG's engagement team repeatedly acquiesced in the use of those discount rates (which had not been adjusted since mid-2002). Furthermore, the engagement team acquiesced in New Century's continued use of other key assumptions that had been questioned by KPMG specialists and neither the engagement team nor those specialists discovered a critical flaw in another key assumption in the Company's residual interest valuation models.
- KPMG failed to plan its audits and reviews appropriately in light of the inherent and control risks of the engagement, including, among other things, known defects in the control environment and certain aggressive assumptions used as part of New Century's accounting practices.
- KPMG's audits and reviews of other financial accounts at New Century, including the allowance for loan losses, mortgage servicing rights, amortization of loan fees and costs, hedging and goodwill, exhibited a general lack of due care in that the engagement team frequently failed to consider seriously repeated concerns expressed by KPMG specialists, failed to adequately question assumptions, and failed to determine if identified errors occurred in prior periods.
- KPMG's SOX 404 audit failed to uncover material weaknesses and significant internal control deficiencies relating to the repurchase reserve process and did not recognize certain recurring deficiencies that epitomized the weak control environment at New Century.
- The engagement team ignored the weaknesses and deficiencies that the SOX 404 audit revealed with respect to residual interests and did not insist upon adequate remediation of those deficiencies.

The Examiner further concludes that, had KPMG conducted its audits and reviews prudently and in accordance with professional standards, the misstatements included in New Century's financial statements would have been detected long before February 2007.

B. Background

New Century retained KPMG as its independent auditor when the Company was formed in 1995. KPMG served as New Century's independent auditor until April 27, 2007, when KPMG resigned soon after New Century filed for bankruptcy protection. At that time, KPMG had performed a substantial amount of the necessary work in connection with its audit of New Century's financial statements for the year ended December 31, 2006, but KPMG resigned before completing that work and never issued a formal audit opinion relating to those financial statements.

1. Scope of Work Performed for New Century

For each year from 1995 through 2006, KPMG was retained by New Century's Audit Committee to perform the annual audits and quarterly reviews of the financial statements of the Company and its related entities. Specifically, as part of the audit services for 2004 and 2005, KPMG audited and issued reports on New Century's consolidated balance sheets and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows. In each of those years, KPMG also performed audits of the effectiveness of New Century's internal controls over financial reporting (the SOX 404 audits). In addition, KPMG conducted quarterly reviews of New Century's interim financial statements for each fiscal quarter for 2004 through 2006. During the applicable period, KPMG performed certain other services for New Century relating to, among other things, tax matters for 2004 and 2005, due diligence for the acquisition of RBC in 2005 and Regulation AB.

2. Staffing of the New Century Audit Engagements

Over time, dozens of KPMG personnel were staffed on the New Century account. Each engagement team was led by an audit engagement partner, whose role included overseeing the audit process, serving as the principal client contact and generally making decisions regarding the staffing of the engagement, including the use of KPMG's internal specialists for certain accounting issues. Operating under the audit engagement partner were generally one or more managers who oversaw the engagement team staff and the day-to-day work performed. Additionally, because New Century is a public company, KPMG assigned a "SEC concurring

partner" to every engagement team to review the audit report and certain work performed by the team and to provide a "negative assurance," which is a statement to the effect that nothing has come to KPMG's attention of an adverse nature or character regarding the financial data reviewed. The KPMG audit engagement partner and concurring partner were required to sign-off on KPMG's audit of New Century's financial statements.

Scott Carnahan was the first audit engagement partner. Carnahan knew New Century's founders Brad Morrice, Robert Cole, and Edward Gotschall, as well as Patti Dodge, from their prior employment with Plaza Home Mortgage Corp. Throughout his tenure as audit engagement partner, Carnahan's primary contact at New Century was Gotschall. After a few years, Carnahan transitioned to the SFG, KPMG's internal specialist group that provided consulting services to clients and assistance to KPMG engagement teams relating to certain financial issues, including the proper accounting treatment for securitizations. Until he left KPMG in late 2006, Carnahan continued to provide advice to New Century's engagement team regarding its residual interest valuations.[633]

Beginning in or around 2000, the New Century audit engagement was led by another KPMG partner, Patrick Kinsella. Kinsella was an experienced auditor and had been at KPMG for over 20 years. He was knowledgeable about the mortgage banking industry and was considered an expert on FAS 133, which deals with accounting for derivative instruments and hedging activities. Initially, Kinsella's primary contact at New Century was Gotschall. When Dodge became CFO of New Century, however, she took a more active role in interfacing with KPMG. In 2003, when Dave Kenneally, a former KPMG manager, became New Century's Controller, he became KPMG's primary contact at the Company and he continued in that role until KPMG's resignation in April 2007.

Kinsella remained the KPMG audit engagement partner through the filing of New Century's Form 10-K for 2004 in the first quarter of 2005. Beginning with the first quarter 2005 review, the entire KPMG engagement team changed with the exception of two first-year associates who had participated in the 2004 audit. The senior level members of the new engagement team included John Donovan, the audit engagement partner, Marc Macaulay, the SEC concurring partner, and Mark Kim, the senior manager assigned to the engagement

[633] In his interview, Carnahan stated that his "official" end-date was March 31, 2007, but he effectively ceased his work for KPMG in December 2006.

beginning with the second quarter 2005 review. Debbie Biddle, the senior associate on the engagement, primarily focused on the 2005 SOX 404 audit. Over the course of the 2005 interim reviews and year-end audit, as many as ten different junior level associates were utilized.

In addition to being new to the New Century matter, both Donovan and Kim were new to KPMG. Macaulay was new to his position as concurring partner, having been promoted to this position in early 2005. Biddle had just transferred to the Los Angeles office from KPMG in the United Kingdom. The senior members of the core engagement team had varying levels of experience with the mortgage banking industry.

Prior to joining KPMG, Donovan had been a partner at Ernst & Young ("E&Y") since 2002. Before E&Y, Donovan worked at Arthur Andersen for 17 years and was a partner when that firm ceased operations. Although Donovan had many years of experience in public accounting, he did not have substantial experience auditing companies in the mortgage banking industry.

Macaulay became the concurring partner on the New Century engagement in the summer of 2005, only a few months after he was named a concurring partner by KPMG. At the time, he had been a partner for less than three years. Macaulay worked primarily with financial institutions, depository or finance-oriented companies, and leasing companies.

Kim joined KPMG for the second time in May 2005, as a senior manager. Kim had numerous jobs after college, few lasting more than two or three years. During his first tenure with KPMG, as a junior staff accountant, Kim mostly counseled Korean clients doing business in the United States. His subsequent experience elsewhere included working as an accountant in-house at Nissan Motors, working at the accounting firm PricewaterhouseCoopers ("PwC") on engagements involving private companies and companies in the automotive sector, and working at a boutique accounting firm that dealt primarily with private companies in the manufacturing, retail and distribution sectors. Before the New Century engagement, Kim's only experience in the mortgage banking industry was at Encore Credit, a small mortgage lending company, where he worked for three years as assistant controller. Kim left KPMG in April 2007.

Biddle played a major role in coordinating the SOX audit despite having virtually no experience auditing U.S. clients and no prior SOX experience. She did not work on the New Century engagement after the 2005 audit was completed in April 2006. Biddle returned to the U.K. in December 2007.

In addition to the core New Century engagement team, several KPMG specialists were involved in conducting tests for annual audits and quarterly reviews for fiscal years 2004 through 2006. The primary KPMG groups involved were SFG, which reviewed New Century's residual interest valuations, the FDR group, which reviewed New Century's accounting for derivatives and hedging, and the FRM group, which performed testing of models, assumptions, calculations and regression analyses related to the Company's accounting for derivatives and hedging.

Specifically, Carnahan and others in KPMG's SFG consulted with the New Century audit engagement team for the annual audits and quarterly reviews from at least 2004 through 2006. Each quarter, SFG reviewed a small sampling of New Century's residual interest valuation models and advised the engagement team of their conclusions and observations.

KPMG's FDR first became involved in reviewing New Century's derivative and hedging activities in connection with the 2005 audit. John Klinge, an audit partner, and Ray Munoz, an audit manager, were the FDR specialists. Their work for New Century continued through the quarterly reviews in 2006 and the incomplete 2006 audit. Klinge and Munoz were responsible for reviewing the Company's accounting for hedges and derivatives and KPMG's audit testing of those transactions, as opposed to the mathematics of the transactions, which was primarily the responsibility of FRM.

3. KPMG's Audit Reports for 2004 and 2005

KPMG's audit reports of New Century's consolidated financial statements for the years ended December 31, 2004 and December 31, 2005 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.[634] Further, KPMG's audit reports on Management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2004 and 2005 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.[635]

C. Overview of the Relevant Professional Standards

In order to determine whether – or to what extent – KPMG performed adequately its duties as New Century's independent auditor, it is necessary to assess KPMG's audit work in the

[634] Form 8-K, Apr. 27, 2007.

[635] *Id.* The Form 8-K notes that KPMG did not include newly acquired RBC Mortgage in its audit of internal control over financial reporting in 2005.

context of applicable professional auditing standards. For audits of public companies, independent auditors such as KPMG are required to comply with the rules of the PCAOB. In addition, PCAOB rules required KPMG to comply with "all applicable auditing and related professional practice standards," including GAAS,[636] in planning, conducting and reporting the results of its audits of New Century's financial statements.[637] KPMG also was required to conduct its reviews of New Century's interim financial statements in accordance with relevant professional standards. Set forth below is a brief overview of the primary standards relevant to the Examiner's assessment of KPMG's audits and reviews of New Century's year-end and interim financial statements.

1. GAAS and GAAP

GAAS consist of ten standards as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with GAAP.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be

[636] Certification of Statements on Auditing Standards, AU § 150.

[637] PCAOB Rule 3100. *See* also PCAOB Rule 3200T (interim rule requiring firms to comply with GAAS unless superseded by the PCAOB). This Section refers both to GAAS and PCAOB rules, as applicable.

> expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

GAAS include Statements on Auditing Standards ("SAS") issued by the Auditing Standards Board of the AICPA, which are codified in *AICPA Professional Standards* under the prefix "AU."[638] Pursuant to GAAS, an independent auditor's report must state whether financial statements are presented "in conformity with" GAAP.[639] GAAP is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time."[640] Practically speaking, GAAP is a set of accounting rules used to prepare, present and report financial statements.

For financial statements to be presented "in conformity with" GAAP, they must follow "established accounting guidance."[641] There is a hierarchy of guidance, and statements and interpretations issued by the Financial Accounting Standards Board ("FASB") are one of the most authoritative sources of guidance. Statements of Financial Accounting Standards ("FAS") issued by the FASB are in the most authoritative category of GAAP, and auditors routinely look to FAS when determining how items should be reported and disclosed in a company's financial statements.[642]

Accountants also may look to other sources of guidance if specific guidance is not contained in FAS. In addition, GAAS instruct that an auditor may follow accounting practices that are "widely recognized as being generally accepted because they represent prevalent practice in a particular industry, or the knowledgeable application to specific circumstances of pronouncements that are generally accepted."[643] In an industry such as mortgage banking that involves complex technical accounting issues, it is thus important for an independent auditor to be familiar with industry practice. For example, FAS 65 discusses the aggregation of certain types of loans when evaluating whether they should be reported at the lower of cost or market

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[638] AU § 150.01.

[639] *Id.*

[640] AU § 411.02.

[641] AU § 411.

[642] Other authorities included in the most authoritative category of GAAP are opinions issued by the Accounting Principles Board, which was dissolved in 1973, and Accounting Research Bulletins issued by the AICPA.

[643] AU § 411.

and provides limited guidance for such aggregation. In the mortgage banking industry, however, aggregation is far more complex than FAS 65 contemplates, and independent auditors often consider industry practices and the interpretation of FAS 65 as applied by financial institutions and other mortgage banking companies when conducting audits and reviews.

2. Audits of Financial Statements

Independent auditors are retained to render an opinion regarding a company's financial statements. Specifically, auditors opine as to the fairness with which financial statements present "in all material respects, [the company's] financial position, results of operations, and its cash flows in conformity with [GAAP]."[644] In the case of a public company, this opinion – or report – is included in the Form 10-K that the company is required to file annually with the SEC.

Management is ultimately responsible for the content of a company's financial statements, [645] and "an auditor is not an insurer and his or her report does not constitute a guarantee."[646] Nonetheless, it is the independent auditor's responsibility to plan and perform the audit such that the auditor obtains reasonable assurance that the financial statements are free of material misstatement whether caused by error or fraud.[647] If a material misstatement is detected in the course of an audit, and management does not correct the misstatement, the independent auditor cannot issue an unqualified ("clean") audit opinion as to the company's financial statements.[648]

a. Due Professional Care and Skepticism

Among other things, GAAS requires that the independent auditor exercise "due professional care . . . in the planning and performance of an audit . . . ."[649] In order to exercise due care, an independent auditor must exercise *professional skepticism* – "an attitude that includes a questioning mind and a critical assessment of the audit evidence."[650] The independent

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[644] AU § 110.01.

[645] AU §§ 110.02 and 110.03.

[646] AU § 230.13.

[647] AU §§ 110.02 and 110.03.

[648] AU § 312.38.

[649] AU § 230.01.

[650] AU § 230.07.

auditor cannot merely rely on a belief that management is honest but instead must obtain "persuasive evidence" to support his or her opinion.[651]

b. Proper Planning

GAAS specifically require independent auditors to develop a plan for the audit that is appropriate in light of relevant facts and circumstances such as the complexity of the business and the company's accounting policies and procedures.[652] The plan must be documented and should be modified as necessary if conditions change.[653] An independent auditor's planning also depends on the auditor's assessment of audit risk, which is the risk that the financial statements may be materially misstated.[654] If an independent auditor assesses the risk as high – or higher than assessed in previous audits of a company – the plan must be adjusted accordingly, for example, by assigning more experienced personnel to the audit or conducting more extensive and rigorous testing.[655] Where the accounting at issue involves estimates, "the risk of material misstatement is generally greater . . . due to the inherent subjectivity in estimating future events and the possibility of using inappropriate data or misapplying appropriate data."[656]

c. Obtaining Sufficient Evidence

In order to satisfy the standard of due care, an independent auditor needs to obtain competent and sufficient evidence[657] such that it provides a *reasonable basis* for forming an opinion on the financial statements.[658] Under the standards governing audit evidence, the "evidence must be both valid and relevant" in order to be "competent."[659] These concepts embody the notion that certain evidence is more reliable and, thus, ought to be accorded more weight by an auditor. GAAS provide the following specific examples:

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[651] AU § 230.09.

[652] AU § 311.03.

[653] AU § 311.05.

[654] The concept of materiality is discussed in Section __ of this Final Report.

[655] AU § 312.17.

[656] AU § 312.36.

[657] Evidence can take many forms, such as written confirmation, a contract or information obtained by observation. AU § 326.17. It also includes the testing of data by "(a) analysis and review, (b) retracing the procedural steps followed in the accounting process, (c) recalculation, and (d) reconciling related types and applications of the same information." AU § 326.19.

[658] AU § 230.11.

[659] AU § 326.21.

- When evidence can be obtained from independent sources outside a company, it provides greater assurance of reliability for an independent audit than evidence secured solely within the company.
- The more effective the internal control, the more assurance it provides about the reliability of the accounting data and financial statements.

The independent auditor's direct personal knowledge, obtained through physical examination, observation, computation and inspection, is more persuasive than information obtained indirectly.[660]

A number of the accounting issues reviewed by the Examiner in this matter – particularly New Century's repurchase reserves and residual interest valuations – present specific evidentiary challenges that are acknowledged by GAAS, as discussed below.

i. Estimates

New Century's repurchase reserve and residual interest valuations involved estimates. GAAS recognize that "there is potential for bias in the subjective factors considered [by management] in determining estimates."[661] By definition, any reserve – such as the repurchase reserve – requires a company to estimate a potential outcome. Accordingly, independent auditors are required to exercise appropriate professional skepticism.[662] In other words, an independent auditor cannot merely rely on an assertion by management that an estimate is reasonable but must conduct appropriate testing and analysis of the factors underlying the estimate. GAAS state that the "auditor's objective when evaluating estimates is to obtain sufficient competent evidence to provide reasonable assurance that:

- All accounting estimates that could be material to the financial statements have been developed.
- Those accounting estimates are reasonable in the circumstances.
- The accounting estimates are presented in conformity with the applicable accounting principles and are properly disclosed."[663]

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[660] AU § 326.21.

[661] AU § 342.04.

[662] AU § 342.0 ("When planning and performing audit procedures to evaluate accounting estimates, the independent auditor considers, with an attitude of professional skepticism, both the subjective and the objective factors considered by management.").

[663] AU § 342.07.

ii. Fair value measurements

Similarly, GAAS acknowledge difficulties in assessing a company's accounting with respect to items that are measured at fair value,[664] as these "measurements are inherently imprecise (that is, they are ordinarily based on assumptions about future conditions, transactions, or events whose outcome is uncertain)." [665] Independent auditors are required to "obtain sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP."[666] GAAS state that the "auditor should test a company's fair value measurements and disclosures." The level of testing that is appropriate depends on (1) the "complexity of the fair value measurements;" (2) the "auditor's understanding of the reliability of management's process for determining fair value measurements;" and (3) the "auditor's assessment of the level of risk of material misstatement associated with the company's process for determining fair values."[667] GAAS also require auditors to test the reasonableness of the assumptions underlying the fair value measurement.[668]

3. Reviews of Interim Financial Statements

The purpose of a review of interim financial statements is "to provide the independent accountant with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to be in conformity with GAAP."[669] A "review consists principally of performing analytical procedures and making inquires of persons responsible for financial and accounting matters."[670] More extensive inquiries and procedures are required if, in the process of conducting a review, the auditor "becomes aware of information that leads him or her to believe the interim financial information may not be in conformity with GAAP" but needs additional information to conclude whether the

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[664] FASB Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, defines the fair value of an asset (liability) as the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced liquidation sale.

[665] AU § 328.05.

[666] AU § 328.03.

[667] AU § 328.23.

[668] AU § 328.26.

[669] AU § 722.

[670] AU § 722.07.

financial statements should be modified.[671] While reviews of interim financial statements are not audits and do not contemplate procedures consistent with an ***audit*** performed under GAAS,[672] independent auditors are required to follow relevant GAAS as they conduct their review procedures.

4. Audits of Internal Controls Over Financial Reporting

In March 2004, the PCAOB adopted PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS 2"). This standard governed KPMG's SOX work during the relevant period.[673] The objective of an internal control audit is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."[674] Further, SOX requires the independent auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary and that other internal control requirements are met.

AS 2 provides that an internal control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. AS 2 defines the following two levels of internal control deficiencies:

- Significant Deficiency - A significant deficiency is defined as an internal control deficiency or combination of control deficiencies that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP such that there is a more-than-remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.[675]
- Material Weakness – A material weakness is defined as a significant deficiency or combination of significant deficiencies that result in a more-than-remote

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[671] AU §§ 722.07, 722.22.

[672] AU § 722.07.

[673] AS 2 recently was superseded and replaced by AS 5. However, during the periods covered by this investigation, AS 2 was the relevant guidance.

[674] SEC Regulation S-X-2-02 (f), 17 C.F.R. § 210.2-02(f) (2006).

[675] The standard specifies that a misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when combined with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement would be more than inconsequential.

likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The key steps in performing a SOX audit pursuant to AS 2 include (1) identifying significant financial accounts; (2) understanding the internal controls associated with such accounts through the review of process narratives developed by the audit client and walkthroughs with relevant audit client personnel; (3) testing the design and operating effectiveness of those controls; (4) identifying any significant deficiencies or material weaknesses; and (5) reporting those deficiencies or weaknesses to the audit client.

AS 2 requires the independent auditor to evaluate the severity of all control deficiencies identified during the review and to inform the audit client of all significant deficiencies and material weaknesses existing at the close of the client's annual reporting period. The independent auditor also is required to issue an adverse opinion on the adequacy of internal controls if any material weakness exists as of the end of the reporting period.

5. Audit Documentation

The documentation requirements for audits of financial statements, audits of internal control over financial reporting, and reviews of interim financial information of public companies are prescribed in PCAOB Auditing Standard No. 3 ("AS 3"). This standard provides guidelines to independent auditors with respect to the contents of their workpapers. Specifically, AS 3 requires workpapers to "clearly demonstrate the work was in fact performed" with sufficient detail to allow "an experienced auditor, having no previous connection with the engagement," to:

- Understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and
- Determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review.[676]

The documentation required depends on a number of factors enumerated in AS 3. As in this matter, where the accounting involves estimates, which are considered presumptively "significant," AS 3 requires "more extensive documentation."[677] Indeed, with respect to New Century's repurchase reserves and residual interest valuations, for example, findings are

[676] AS 3.06.

[677] AS 3.07-3.08.

presumptively "significant" for purposes of AS 3, and therefore should have been documented more extensively by KPMG in its workpapers.

6. Communications with the Audit Committee

The professional standards also require independent auditors to communicate certain matters to the client's audit committee.[678] In relevant part, independent auditors must report the following:

- **The Independent Auditor's Responsibility Under GAAS** –The independent auditor must communicate the level of responsibility assumed for certain matters under GAAS and that an audit is designed to obtain reasonable, rather than absolute, assurance about the financial statements.
- **Significant Accounting Policies** – The independent auditor is required to discuss the initial selection of, and changes in, significant accounting policies or their application, the methods used to account for significant unusual transactions, and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- **Management Judgments and Accounting Estimates** – The independent auditor is required to communicate the process used by management to formulate particularly sensitive accounting estimates and the basis for the independent auditor's conclusions regarding the reasonableness of those estimates.
- **Independent Auditor's Judgments About the Quality of the Company's Accounting Principles** – The independent auditor is required to communicate certain information relating to his or her judgments about the quality, not just the acceptability, of the company's accounting principles.

D. Findings

1. Circumstances Surrounding the Overall Management of the Engagement Team Created A Higher Risk That KPMG Would Not Detect A Material Error.

During the relevant period, KPMG faced a number of challenges with respect to the New Century engagement, including staffing, a difficult client, and a poorly handled internal disagreement that almost delayed the filing of New Century's Form 10-K for 2005 and resulted in the consideration by the Audit Committee of replacing KPMG. These factors contributed to KPMG's failure to detect the accounting errors and material misstatements at issue in that they increased the attendant risks of the engagement. Thus, the Examiner believes that a consideration of these factors is essential to a proper assessment of KPMG's conduct and underlying responsibility.

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[678] AU § 380.02.

Although weaknesses in the engagement's staffing alone may not have created unacceptable levels of risk, the engagement would have benefited from stronger and more experienced auditors in the industry, particularly where, as in this matter, the team had to deal with difficult and strong personalities at the Company and an inadequately staffed Accounting Department. This could have led to an earlier change in the residual interest discount rate, an earlier detection of certain weak internal controls and more candid communications with the Audit Committee.

a. KPMG Staffing

The 2005 engagement team, in particular, was not staffed with auditors with sufficient experience in the client's industry and/or relating to the particular tasks to which they were assigned. As discussed previously, the entire 2005 engagement team, with the exception of two junior auditors, was new to the New Century engagement. The team also consisted of auditors who were relatively inexperienced in the mortgage banking industry. The new engagement partner, Donovan, had many years of experience in public accounting but did not have significant experience in the mortgage banking industry, as he acknowledged in his self-evaluations. Kim's experience in the industry was limited to his brief tenure at Encore before joining KPMG.

In addition to new supervisors, a substantial amount of the team's 2005 work with respect to two critical accounting policies—the repurchase reserve and residual interest valuation—was performed by first-year auditors with no substantive experience in these areas. The auditor who reviewed the accounting related to residual interest valuation admitted to the Examiner that the models were more complex than he was comfortable evaluating and that he did not understand the complete models. Although the team sought the input of KPMG's internal valuation specialists, the specialists had little or no control over the conclusions reached by the engagement team and their concerns were often dismissed by the engagement team leaders, as discussed above.

Moreover, as noted above, Biddle, the in-charge senior associate for the 2005 SOX 404 audit, had virtually no experience with auditing internal controls under SOX or even U.S. GAAP issues prior to beginning her work on the New Century audit. In April 2006, as part of KPMG's engagement risk assessment and approval process, Macaulay indicated he had concerns about

manager staffing, and a manager with relevant experience, Veronica Wong, was added to the team to focus specifically on the SOX component of the audit.[679]

Finally, not only was the engagement team weak in experience, but Donovan and, to some extent, Kim, appeared unwilling to challenge the client, and in some instances may have acted as advocates for the Company. For example, a dispute arose between a KPMG FDR specialist and the engagement team in March 2006 that threatened the timely filing of New Century's Form 10-K for 2005, as discussed below. Donovan was frustrated with the specialist's concerns – which were later determined to be legitimate– and was able to get KPMG's "clean" opinion issued despite those concerns. A senior KPMG partner, in a telephone conversation with Dodge, commended Donovan and Kim for acting as "advocates" of New Century "without crossing the line of independence."

Another example is how, despite repeated concerns from KPMG's own internal specialists (SFG) regarding the discount rate used to value New Century's residual interests, as discussed above in Section VI.B. and below, Donovan supported the Company's discount rates in the face of opposition first from New Century Management and later from a Board committee to increasing those rates.

A third example relates to an email request from a junior auditor to Tony Sanchez seeking what appeared to be legitimate information on a number of audit issues, which Sanchez forwarded to Kenneally. Kenneally then forwarded the e-mail to Kim, complaining about the junior auditor and stating that he is not the "KPMG Training Center." In response, instead of recognizing the validity of the auditor's questions, Donovan adopted Kenneally's view that the questions required obvious answers and that the questions should have been filtered first, while Kim pointed out that "some of the answers were not straight forward [sic] (*e.g.*, Look for residuals to see if they are still on the books").

In addition, on two occasions, Kim proactively suggested in mid 2006 to the Accounting Department, and in particular to Sanchez and Kenneally, changes to the Company's estimation process for repurchase reserve and LOCOM that had the effect of decreasing the reserve and increasing earnings, as discussed in Section VI.A. and below.

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[679] Macaulay has denied that the concerns resulted from any perceived inadequacies in the performance of the 2005 engagement team.

Donovan's focus on preserving the client relationship is reflected in his performance evaluations for the applicable period. In particular, with respect to New Century, Donovan stated in three different appraisals in 2005—a "goal setting" review, an interim review and a year-end review—that there had been "no loss of client service" and that he had developed "good relationships" with the client's team. In another review in 2006, Donovan stated that he had to deal with "significant client service and technical issues that I was able to overcome and find a good middle ground for the client."

b. New Century's Accounting Department Personnel

The engagement team's lack of experience was compounded by the fact that New Century's accounting function was weak and was led by a domineering and difficult Controller. The Controller, KPMG alumnus Dave Kenneally, was the engagement team's primary contact at New Century. By many accounts, Kenneally was a difficult, condescending and quick-tempered Controller who intimidated junior staff accountants when they were requesting information from the Company. KPMG provided the following descriptions of Kenneally to the Examiner:

- One KPMG professional described Kenneally as "condescending" and said that he "liked to push his weight around." She also stated that Kenneally often made fun of Donovan and Kim in their presence.
- Another KPMG engagement team member stated that Kenneally had a tendency to raise his voice and left a bad impression personally because of his way of dealing and interacting with both employees of New Century and the auditors.
- Donovan recognized that Kenneally was "difficult with the junior members" of the engagement team.
- Kim observed that Kenneally was difficult and conceited, that he would balk when new issues arose and that junior auditors would encounter difficulty when attempting to obtain information from Kenneally. He also noted that the junior members of the team were intimidated by Kenneally.

Kenneally also was one of only a few CPAs in the entire Accounting Department at New Century, and the Examiner observed that Kenneally was the keeper of a large amount of critical accounting information and often the only source of knowledge about the Company's accounting policies and procedures. This fact was noted in an e-mail from Kim to Donovan in September 2006 in which Kim stated that "Dave seems to know the answers for everything and anything and the rest of the accounting department is on almost the same boat as the audit team is – little knowledge of what's going on. This intimidates everyone in the engagement team."

These factors appear to have contributed to the bad reputation of the New Century engagement at KPMG and the high turnover in the engagement team. Kim complained to Donovan in the same e-mail noted above that "we will never get a good team out there because of the reputation the engagement has." In an e-mail to Kenneally, Sanchez observed, with respect to the KPMG's engagement team's experience, that New Century was not getting the "A team." When asked about the engagement's bad reputation, one KPMG engagement team member informed the Examiner that it was based on a number of factors, including that it required long hours and involved difficult people, such as Kenneally and Kim.

Despite these circumstances, Kim and Donovan both stated that they believed they ultimately obtained all of the information they needed from Kenneally and that they were not intimidated by him.

c. KPMG's Probationary Status in 2006 Due to the 2005 Form 10-K for 2005 Filing Issue

As noted above, an issue came to a head on the eve of filing New Century's Form 10-K for 2005. Specifically, there was a disagreement related to a review of the Company's hedge accounting practices and documentation by John Klinge and Ray Munoz, KPMG's FDR specialists, which held up KPMG's issuance of its audit opinion. Although KPMG ultimately issued its opinion and the Company was able to file its Form 10-K on time, the event damaged the relationship and put KPMG personnel under tremendous pressure to convince the Company that it should continue to retain KPMG.

In the fall of 2005, Klinge and Munoz were assigned to assist in the audit of the Company's 2005 financial statements in order to provide specialized expertise and "quality control" with respect to derivatives and hedging issues that arose in the context of the audit. Among Klinge's primary tasks was determining whether the Company's hedge accounting conformed to FAS 133 (*Accounting for Derivative Instruments and Hedging Activities*). Many weeks later, however, Klinge and Munoz had not received any of the documentation they had requested in order to begin their review. Klinge alerted Donovan to this fact in an e-mail dated January 17, 2006. Klinge cautioned Donovan that the delay might complicate the timely resolution of any accounting issues discovered in connection with their analysis.

Despite the fact that Klinge had indicated on January 17 that he had received no documents to begin his analysis, two weeks later, on February 1, 2006, Donovan represented to New Century's Audit Committee that an "outside expert" had been engaged to review the

Company's derivatives documentation, and that the Company's hedge accounting satisfied FAS 133. Donovan did not consult Klinge prior to making this representation of FAS 133 compliance to the Audit Committee because Donovan "didn't think there was going to be an issue." Klinge was unaware that Donovan had made this representation to the Audit Committee.

Over the course of February 2006, a disagreement arose between Donovan and Klinge stemming from Klinge's unwillingness to "sign-off" on the Company's hedge accounting because he had not seen sufficient documentation to support the Company's cash-flow hedging practices. Per KPMG policy, until the disagreement was resolved, KPMG could not release its opinion. Ultimately, in mid to late February, Donovan brought in KPMG's Department of Professional Practice ("DPP") to attempt to resolve the disagreement.[680]

On March 2, 2006, Donovan participated in another Audit Committee meeting, and informed the Committee of an "open audit issue" regarding New Century's hedge accounting and a potential deficiency relating to the Company's hedging documentation. Donovan indicated that the issue "should be resolved in the next day or two after KPMG's [DPP] had finished reviewing all of the documentation." Soon thereafter, the DPP gave Donovan a "verbal approval" of the Company's hedge accounting, which he then passed along to Kenneally. On March 3, 2006, Kenneally sent an e-mail to the Board of Directors in which he stated: "KPMG's Department of Professional Practice has accepted our hedge accounting treatment . . . the result is a PASS, and as we discussed, there will be no adjustment to the financial statements." Kenneally forwarded this e-mail to Donovan and Kim. Klinge informed the Examiner that he had never seen Kenneally's e-mail and did not know that any such representation had been made to the Board of Directors.

The issue, however, had not yet been resolved to Klinge's satisfaction and it was still holding up KPMG's audit opinion, a fact that, according to then-CFO Dodge, was not communicated to New Century until just hours before the Company's Form 10-K filing deadline on March 16. In an e-mail exchange in the late evening of March 15, 2006, Kim learned that Klinge was not prepared to sign off on the FDR review and Kim informed Donovan. In an e-mail exchange with Klinge on the morning of March 16, Donovan stated: "I am very

[680] The DPP is the national office of KPMG that is responsible for policy, quality control and standards. The partners and managers in DPP are available to consult with engagement teams as needed. In certain instances, such as disagreements among members of an engagement team, KPMG's internal procedures require DPP involvement.

disappointed we are still discussing this. As far as I am concerned we are done. The client thinks we are done. All we are going to do is piss everybody off."

Ultimately, KPMG issued its audit opinion minutes before the Form 10-K was due and New Century timely completed its filing deadline. A high-ranking member of DPP, Terri Iannaconi, authorized Donovan to issue KPMG's audit report following a lengthy emergency conference call among Donovan, Macaulay, Kim and Klinge and various members of DPP. Iannaconi also instructed Klinge to prepare and forward to the engagement team a sign-off memorandum and directed Kim to prepare a "disagreement memorandum" to document the dispute.[681]

The members of New Century's Audit Committee expressed great annoyance with KPMG over this sequence of events. According to the Chair of the Audit Committee, Michael Sachs, the Committee spent much of its March 17, 2006 meeting "yelling and screaming" at Donovan and Kim about this issue. The minutes reflect that Richard Zona "expressed his displeasure that Donovan had given the Committee the impression that this matter was near resolution at the March 2nd meeting and there was no indication to the contrary until just before the filing deadline." Several Audit Committee members felt that Donovan, personally, was to blame for the crisis, and that the problem would not have arisen under Donovan's predecessor engagement partner, Kinsella.

Indeed, the Audit Committee decided that it would defer its decision to retain KPMG for the 2006 audit until an explanation was provided regarding the events surrounding the FDR dispute. The Company's full Board of Directors also considered the possibility of replacing KPMG. For the time being, however, the Audit Committee agreed to retain KPMG to perform a review of the Company's financial statements for the first quarter of 2006.

During this probationary period, Donovan and Scott London, a KPMG partner responsible for the firm's audit practice in the Los Angeles region, made a presentation to the Audit Committee during its May 9, 2006 meeting. Donovan and London gave the Committee a chronology of the events leading up to the last-minute filing crisis and discussed in greater detail

[681] Iannaconi realized the following day when she reviewed Klinge's memorandum that open issues remained, which presented a potentially significant problem in that KPMG had issued its clean opinion already. The disagreement was not resolved completely, in fact, until the following month. Klinge eventually received sufficient documentation to form a conclusion, which was that the accounting treatment was improper and had resulted in a misstatement of several million dollars. The misstatement ultimately was deemed immaterial.

the hedging issue that had led to the disagreement. They also "commit[ed] to the Company that a situation like this will never happen again" and promised to involve the FDR at an earlier stage during quarterly reviews and annual audits "such that any problems will be identified early and no surprises will occur." Following this May 9 meeting, the Audit Committee agreed to retain KPMG for the entire 2006 audit cycle.

This issue also cost KPMG goodwill with Kenneally. He told the Examiner that he had been furious over the "near-disaster" with the 2005 Form 10-K filing. He said that he met privately with Donovan during this period, who assured him that such problems would not occur in the future. Kenneally noted that he and New Century were provided exceptional client service by KPMG over the next few months as a result.

Donovan acknowledged to the Examiner that he was concerned that KPMG would lose the New Century account as a result of this sequence of events. While the Examiner has not found definitive evidence that Donovan failed to remain independent, as required by AU § 220, the Examiner notes that this concern may have influenced the review and audit planning process in 2006. In particular, it is possible that Donovan and Kim were not as skeptical as they might otherwise have been with regard to critical assumptions, such as with respect to the residual interest discount rate, as discussed in Section VI.B. Donovan and Kim also may have looked for ways to add unique value in order to salvage KPMG's reputation, such as by providing proactive (though erroneous) advice in connection with the repurchase reserve calculation methodology, as discussed in Section VI.A. and below.

2. KPMG Provided Erroneous Advice to New Century Regarding the Calculation of its Repurchase Reserve and Failed to Detect A Material Misstatement.

New Century's Allowance for Loan Repurchase Losses was identified as a critical accounting policy in both the Company's public filings and in KPMG's audit planning documents.[682] As a critical accounting policy, the repurchase reserve was considered to have a high subjective element and a possible material impact on the Company's financial statements. It also was an area of concern to New Century's Audit Committee and was generally discussed by KPMG at Audit Committee meetings throughout 2005 and 2006.

[682] *See, e.g.*, Form 10-K for 2005 at pp. 65.

Despite its status as a critical accounting policy, New Century's repurchase reserve estimation process was not well organized and documented. KPMG noted in its audit of New Century's internal controls in 2004, 2005, and 2006 that New Century had an internal control weakness because it had not adopted formal policies and procedures for the repurchase reserve estimation process. KPMG considered the deficiency inconsequential, however, and did not change any of the substantive audit procedures or tests of details from 2004 through 2006. The Examiner finds, as discussed above, that it was unreasonable for KPMG to conclude that this deficiency was inconsequential without performing additional substantive procedures and testing, the results of which should have been documented in its audit workpapers.

KPMG also observed a considerable increase in loan repurchases in the fourth quarter of 2004, and then a more than doubling of repurchases in 2005 compared to 2004, from $135.4 million to $332.1 million. Nevertheless, KPMG failed to perform any increased procedures or testing of New Century's repurchase reserves. Even in 2006, when KPMG changed the Risk of Significant Misstatement (RoSM), which reflects KPMG's assessment of the risk arising from error for each audit area and determines the quantity and quality of the audit steps for that area, from Low to High, it failed to increase any of the substantive audit procedures or tests of details in response to the change of the RoSM.

KPMG performed detailed quarterly reviews of New Century's repurchase reserve estimation process and sometimes, but not always, prepared workpaper memoranda discussing the reasonableness of New Century's reserve calculation. KPMG's workpapers for the first and second quarterly reviews for the 2005 audit all concluded: "Based on the discussion above, methodology, estimates and data used in determining the Company's reserve for potential future repurchases and expected losses, the amount reserved for based on the Company's analysis . . . appears reasonable."

As discussed in Section VI.A., however, New Century's repurchase reserve was underestimated by at least $21.3 million at December 31, 2005. In 2006, the reserve was underestimated by $42.8 million, $103.3 million and $190.6 million, respectively, in each of the first three quarters. KPMG failed to detect these material misstatements in its audits and reviews due, in part, to an unreasonable reliance on management's representations, estimations and assumptions. KPMG also suggested changes to New Century's repurchase reserve calculation

methodology that were contrary to GAAP, which contributed to the misstatement as described further below.

a. KPMG Should Have Considered Whether New Century Needed to Increase Its Reserve for the Growing Backlog of Repurchase Requests.

As described more fully in Section VI.A., to calculate its repurchase reserve, New Century multiplied whole loan sales in the current period by a fixed percentage. This percentage was derived from the ratio of actual repurchases made by the Company during a specified historical time period to all whole loan sales made over that same time period. The percentage was changed by the Company over time. In 2005 and 2006, the Company tweaked the duration of the historical period used, and the result was an increase in the percentage. By the end of 2006, however, New Century was simply increasing the percentage without regard to the actual ratio in order to account for worsening market conditions.

However, New Century never factored repurchase requests or claims already received by the Company into its calculation. In combination with the faulty assumption that claims were received, evaluated, processed and repurchased within 90 days of the date the whole loans were sold (the 90-day look-back assumption), this failure to take into consideration repurchase claims proved to be a critical error. The Company failed to reserve at all for these Backlog Claims – the large and growing amount of repurchase claims relating to loans sold before that 90-day period. KPMG was aware that New Century failed to consider the Backlog Claims in its estimation process but never insisted that New Century do so. Indeed, KPMG approved of New Century's calculation and continued to defend it in interviews with the Examiner.

New Century's repurchase reserve calculation assumed that all repurchases were made within 90 days of the date New Century sold the loans. For this reason, New Century assumed that any potential repurchases outstanding at the end of any particular quarter (*e.g.*, first quarter) were either repurchased or no longer susceptible to repurchase as of the end of the next quarter (*e.g.*, second quarter). Using this example, the calculation for the second quarter, therefore, only took into consideration potential repurchases related to whole loan sales for the second quarter (the previous 90 days) and assumed that no potential repurchases still existed from the first quarter or prior periods; that is, the calculation was based on an assumption that no Backlog Claims existed.

The Examiner interviewed KPMG about the basis for this 90-day look-back assumption. KPMG reported that New Century represented that the majority of its repurchases were completed within 90 days of the date New Century sold the loans. KPMG told the Examiner that it tested this assumption in two ways. First, it reviewed the loan sale agreements to confirm that they contained provisions requiring repurchase in the event of early payment defaults only within 90 days of purchase. The agreements provided that New Century could also be required to repurchase loans, with no time constraints, in the event of a breach of certain representations and warranties. KPMG claims that such repurchases, however, were minimal and did not warrant expanding the period of the look-back. Second, KPMG reviewed New Century's repurchase log, which contained historical information about repurchases (including the date the loans were sold and the date the loans were repurchased) to confirm that repurchases generally were actually being made within 90 days of the date of sale.

Even a cursory review of these documents, however, should have revealed that reserving only for potential repurchases of whole loan sales for the last 90 days was unreasonable. First, the loan sale agreements were not uniform in any respect. The repurchase provisions varied from agreement to agreement. Accordingly, KPMG could not have determined that all the agreements required repurchases within 90 days, and it should have been clear that additional testing was required. Second, the Examiner reviewed the repurchase log, and it reflects that the dates loans were repurchased were more—and sometimes much more—than 90 days from the date the loans were sold. Thus, KPMG's review of the repurchase log could not have confirmed that the majority of repurchases were made within 90 days of sale. KPMG failed to adequately test this critical assumption.

The flawed 90-day look-back assumption enabled the backlog of repurchase claims to exist and grow from period to period. By starting over each quarter and only reserving for potential repurchases of loans sold within the most recent quarter, New Century was failing to reserve for the Backlog Claims – any potential repurchases of loans sold in any prior periods. As market conditions worsened, and repurchases increased, the number of Backlog Claims outstanding from prior periods grew substantially and rolled over from period to period. New Century was aware as of the end of 2004 that repurchases were increasing as a result, at least in part, of repurchases rolling over from prior periods. KPMG's SOX 404 audit process and audit apparently failed to detect this critical piece of information, or at least to realize its significance.

In connection with its 2005 audit, however, KPMG did, in fact, obtain this critical information but then did nothing with it.

On February 10, 2006, Christina Chinn, the KPMG junior auditor responsible for reviewing New Century's repurchase reserve calculation specifically solicited and obtained from Robert Lent in New Century's Secondary Marketing Group the amount of repurchase requests outstanding as of December 31, 2005. Chinn told the Examiner that Mark Kim asked her to obtain this information. Lent responded that New Century had $188 million in outstanding repurchase requests as of December 31, 2005.[683] A substantial portion of these $188 million in outstanding repurchase requests likely were Backlog Claims relating to loans sold prior to the fourth quarter of 2005 that were not being accounted for in the repurchase reserve calculation.

While in possession of this critical information, KPMG approved New Century's repurchase reserve calculation which ignored the claims received by the Company. Instead, as with all prior periods, the calculation estimated the amount of repurchases based only on historical actual repurchases as a percentage of whole loan sales applied to the whole loan sales made in the fourth quarter of 2005. At year-end 2005, using New Century's traditional method of simply calculating the historical percentage of whole loan sales that the Company repurchased (0.659%) and applying that percentage to the whole loans sales from the fourth quarter of 2005 (approximately $10.7 billion), New Century estimated only approximately $70 million in potential future repurchases, although New Century was already in possession of repurchase claims totaling $188 million.

KPMG was aware of these $188 million in outstanding claims and even referenced them in the repurchase reserve workpaper for the period, but did not take them into consideration whatsoever in evaluating the sufficiency of New Century's repurchase reserve calculation. The audit workpapers contain no evidence of additional testing or any other substantive procedures performed on these outstanding repurchase claims as of December 31, 2005 to determine if any or all were Backlog Claims relating to loans sold prior to the fourth quarter of 2005 that were not being accounted for in the repurchase reserve calculation. Chinn could not even explain why

[683] Lent's e-mail also noted that $157 million of the $188 million were for EPD. The other $31 million (16%) were thus presumably related to breaches of representations and warranties, for which there was no time limitation on an investor's ability to submit a repurchase request. This high percentage of requests for such breaches is additional evidence that that the 90-day look-back period was insufficient to adequately account for New Century's loan repurchase liability.

KPMG requested this information or if KPMG had ever requested it from New Century in any prior or subsequent periods.

Applying even the simplest of calculations to this information – for example, the percentage of repurchase claims that New Century ultimately repurchased historically – would have revealed that New Century was substantially underreserved. A review of the loan sales that were the subject of the repurchase claims would have revealed that the claims related to sales made in prior periods such that reserving only for sales made in the last 90 days was a critical error. Comparing the number to prior periods and to subsequent periods would have revealed that the number of outstanding repurchase claims was growing period to period, which would have been a clear sign of a mounting problem, especially given that New Century itself had done nothing to adjust its methodology to account for the increasing amount of Backlog Claims. KPMG, however, appears to have done nothing with this critical information as well, and instead, merely made a passing reference to it in a workpaper. KPMG failed to consider the financial statement impact of these repurchase claims or further investigate the treatment of these claims whatsoever. Such an oversight constitutes a lack of due professional care, as required by GAAS, and a failure to obtain sufficient competent evidence to provide reasonable assurance that the accounting estimate was reasonable and presented in conformity with applicable accounting principles.[684]

Kim told the Examiner that disregarding actual repurchase claims received by the Company, and instead only estimating repurchases based on the historical actual repurchase percentage applied to the most recent period's whole loan sales, was a reasonable method of estimating New Century's repurchase liability. Kim also told the Examiner that he holds this belief even today with knowledge that the growing amount of Backlog Claims rolling over period to period was substantially more than the Company's estimate and a significant factor in the Company's need to restate its 2006 quarterly financial statements. The Examiner concludes that Kim's alleged continued belief in this regard is utterly without factual basis and lacks basis in accounting standards as well.

The same KPMG 2005 repurchase reserve analysis workpaper noted that repurchases had more than doubled during 2005 compared to 2004 from $135.4 million to $332.1 million. Notwithstanding this substantial increase in repurchases, and direct knowledge of an additional

[684] AU § 342.

$188 million in outstanding repurchase claims, New Century's repurchase reserve actually *decreased* slightly from the end of 2004 to the end of 2005. KPMG made note of this in its workpaper but Chinn could not recall any related discussions or concerns by anyone within KPMG. Instead, KPMG concluded that the amount reserved was reasonable without any additional inquiry. This also demonstrates a lack of due professional care as required by GAAS.[685]

b. KPMG Erroneously Assumed That New Century Was Reserving for Lost Interest Recapture As Required by GAAP.

Under FAS 5, New Century was required to reserve for the interest to which an investor was entitled but did not receive, while it held a loan, due to a default by the underlying borrower. New Century was required to pay this lost interest (referred to in this Report as "Interest Recapture") to the investor at the time it repurchased the loan. New Century did not begin to reserve for this lost interest until the third quarter of 2006.

KPMG was aware that New Century was required to reserve for lost interest but incorrectly assumed that the reserve included such an interest component. Kim admitted to the Examiner that he specifically told Tony Sanchez in September 2006 that *only* premium and interest to be repaid to the investor needed to be included in the reserve. Although, as discussed below, this was patently erroneous advice, it confirms that KPMG knew that GAAP required that interest be included in the reserve. Much earlier than September 2006, however, it appears that Kim inquired about whether New Century's reserve included interest. Specifically, Chinn recalled a meeting she attended with Kenneally and Kim where Kim specifically asked Kenneally whether New Century's repurchase reserve included an interest component. Chinn recalled that Kenneally responded that interest was included in the component of the reserve known as "Estimated Losses on Future Repurchases."

KPMG did nothing, however, to test this representation. Chinn confirmed that KPMG took Kenneally's representation at face-value and then repeated it in its repurchase reserve workpaper for the 2005 audit. In fact, the "Estimated Losses on Future Repurchases" did not include an interest component. It consisted solely of the estimated loss on the sale of repurchased loans based on the historical losses incurred over the prior three years. Had KPMG

[685] AU § 342.

performed even minimal testing of Management's representations, it would have determined that, in violation of GAAP, the reserve did not account for the Interest Recapture component.

Interest Recapture was not included in the reserve calculation until the third quarter of 2006. KPMG prepared a workpaper memorandum the third quarter of 2006 discussing the change to the calculation to include Interest Recapture. Chinn, who had prepared the 2005 year-end workpaper and had left the New Century engagement at the end of the second quarter 2006 review, was shown the third quarter 2006 memorandum discussing the change to include interest. She stated that the new interest component discussed in the memorandum was the same component she thought was already included back in the 2005 audit and which her workpaper noted, incorrectly, was included.

KPMG's failure to test whether interest was, in fact, included in the repurchase reserve calculation for all applicable periods (as required by GAAP) violated GAAS. KPMG's 2005 audit procedures and 2006 first and second quarter reviews failed to identify this departure from GAAP. KPMG failed to obtain sufficient competent evidence to provide reasonable assurance that the accounting estimate was reasonable and presented in conformity with applicable accounting principles and in doing so, breached the standard of due care.[686]

c. KPMG's Suggestion That New Century Remove Inventory Severity From Its Repurchase Reserve Calculation Was Contrary to GAAP.

When New Century repurchased loans from investors, it was required under FAS 140 to book the repurchased loans at fair value at the time of repurchase. The difference between the price it paid to repurchase the loans and the fair value of the loans was then to be debited to the repurchase reserve account. For example, if New Century was required to repurchase a loan for $100,000, but that loan was only worth $95,000 at the time New Century repurchased it, the loan should have been booked at $95,000 and the repurchase reserve account debited the difference of $5,000.

Through the first quarter of 2006, New Century did not technically comply with all the requirements of FAS 140, but instead performed a calculation as part of its repurchase reserve that amounted to an approximation of the FAS 140 requirements. At the time of repurchasing a loan, New Century booked the repurchased loans at par value in LHFS and then, at the end of the

[686] AU §§ 230, 326, and 342.

quarter, performed a LOCOM analysis of these loans and booked a LOCOM valuation amount that was reported as a contra-asset as part of LHFS. This LOCOM valuation amount was reflected in New Century's repurchase reserve calculation as MTM on Repurchases Not Yet Sold and is referred to in this Report as "Inventory Severity." Although technically not in strict compliance with GAAP, the method employed by New Century approximated the requirements of FAS 140.

In the second and third quarters of 2006, however, New Century removed the Inventory Severity component of the repurchase reserve calculation after Mark Kim told Tony Sanchez that this loss was already accounted for in the Company's general LOCOM analysis. In or around July 2006, in connection with the second quarter review, Kim told Sanchez that because the LHFS was subject to the Company's general LOCOM analysis, performing the MTM on Repurchases Not Yet Sold was, in effect, double counting and resulted in New Century being over-reserved. Sanchez and Kenneally then followed up on this suggestion, conducted a minimal amount of their own research and removed the LOCOM valuation component from the calculation of the repurchase reserve. By removing this component, however, New Century eliminated the "approximation" to the requirements of FAS 140 for the second and third quarters of 2006, which left the Company's calculation in violation of GAAP.

Kim acknowledged to the Examiner bringing the issue to Kenneally's attention and having a discussion concerning it at some point in time, but claimed to not have specifically recommended a change. In fact, Kim claimed to have not even known a change was ultimately made in the second quarter until he reviewed the repurchase reserve in connection with the 2006 audit. Based on a number of factors, including interviews of Sanchez, Kenneally and members of the Audit Committee who were present at a 2007 Audit Committee meeting in which Kim did not deny having known about and/or suggested the change (Kim also admits this occurred), and also based on KPMG's Balance Sheet Analytics workpapers for the second quarter 2006 in which Kim specifically revised a paragraph describing the change and which references a discussion between Kim and Sanchez about the change, the Examiner does not find credible Kim's denial that he suggested the change or that he did not know a change was then made. The Examiner finds that Kim's suggestion was, at minimum, the catalyst for the change, *i.e.*, but for his suggestion, it is unlikely that Sanchez or Kenneally would have independently decided to remove Inventory Severity from the repurchase reserve calculation.

Christina Chinn reviewed the repurchase reserve in connection with KPMG's second quarter 2006 review. When she noticed that this component of the reserve had been removed from the calculation, she sought a memorandum from New Century discussing the basis for the removal but was told by Kim in an e-mail, "Please do not ask the client regarding this anymore." Accordingly, no further analysis was performed on the second quarter 2006 change, which was repeated in the third quarter of 2006.

The evidence reviewed by the Examiner indicates that Donovan also was aware of the second quarter 2006 change removing Inventory Severity from the repurchase reserve calculation. When interviewed, Donovan claimed that he knew nothing about the change until a discussion with Kenneally in January 2007, which ultimately led to the realization of the need for a restatement. Kim, however, told the Examiner that he had discussed the issue with Donovan before ever discussing it with Kenneally. The Examiner does not find Donovan's claimed ignorance of the second quarter 2006 change credible. Donovan confirmed that he reviewed KPMG's Balance Sheet Analytics workpapers for the second quarter of 2006. He even confirmed that his handwriting appears on the very section of the workpaper discussing the second quarter change, and that he wrote "let's discuss" on the workpaper. It is clear to the Examiner that Donovan was aware of the change at least as of the time of KPMG's second quarter review.

Donovan and Kim attended the July 26, 2006 Audit Committee meeting for the second quarter at which they made a presentation regarding KPMG's second quarter review, addressing specifically New Century's repurchase reserves. Notwithstanding their knowledge of and participation in the change, neither Donovan nor Kim informed the Audit Committee that a change had been made in the calculation methodology or that there would be a resulting change in the LOCOM valuation account.

At a time when KPMG was aware, as evidenced in its own workpapers, that market conditions were worsening and repurchases were increasing, KPMG made a recommendation to New Century to remove a component of the repurchase reserve that had the effect of *decreasing* the reserve – actually overvaluing LHFS due to the way New Century accounted for Inventory Severity – and then failed to inform the Audit Committee of the change to this critical accounting policy. Kim's suggestion to New Century to remove Inventory Severity from the repurchase reserve calculation resulted in New Century's failure to comply with GAAP. KPMG's

subsequent second quarter 2006 review then failed to identify the material departure from GAAP, in that it failed to recognize that Management's calculation of the repurchase reserve did not consider Inventory Severity.

These findings indicate that KPMG's second quarter 2006 review of the repurchase reserve failed to meet professional standards in several respects. KPMG failed to conduct adequate analytical procedures, inquiries, and other procedures to address whether the accounting estimate was reasonable and presented in conformity with applicable accounting principles. KPMG also failed to inform the Audit Committee of its recommended change to the repurchase reserve calculation, and in doing so, breached the standard of due care.[687]

d. KPMG Erroneously Advised New Century To Remove Future Loss Severity from Its Repurchase Reserve Calculation Contrary to GAAP.

Under FAS 140 and FAS 5, New Century was required to reserve for potential losses on the future repurchase of loans referred to in this Final Report as "Future Loss Severity." Future Loss Severity is the estimated excess of the repurchase price over the expected fair value of the repurchased loan on the date of repurchase. Through the second quarter of 2006, New Century's repurchase reserve calculation properly included an estimate of Future Loss Severity, but, as discussed above, only for potential repurchases related to whole loan sales for that quarter (previous 90 days) and not for any Backlog Claims. In the third quarter of 2006, however, New Century removed Future Loss Severity from its calculation based again on advice it received from Kim.

In September 2006, Kim advised Sanchez that the repurchase reserve only needed to include the premium and lost interest to be refunded to the investor upon repurchase of the loan (Premium and Interest Recapture). Accordingly, consistent with his second quarter 2006 suggestion to remove the loss for loans that had been *already repurchased*, Kim further recommended removing the potential loss for *future repurchases*.[688] Kim had a conversation with Sanchez in September 2006 in which he incorrectly advised Sanchez that there was no

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[687] AU §§ 230 and 722.

[688] Chinn stated that as early as the third or fourth quarter of 2005, in a meeting with Kenneally, Kim questioned the appropriateness of including in the reserve the potential loss on the sale of repurchased loans that had not yet been repurchased. At the time of her interview, Chinn was vaguely familiar with the term "loss severity" but was not familiar with it at the time of the referenced meeting. She did not recognize Kim's inquiry to be questioning the inclusion of loss severity.

accounting literature applicable to the repurchase reserve and that only premium and interest to be refunded to the investor needed to be included in the reserve. When interviewed by the Examiner, Kim acknowledged that at the time of his conversation with Sanchez, he was not aware that paragraph 55 of FAS 140 applied to the repurchase reserve and acknowledged that his advice had been contrary to GAAP. Sanchez confirmed the substance of his conversation with Kim in an e-mail to Kenneally.

In connection with its third quarter 2006 review, Chinn prepared a workpaper, entitled "Repurchase Reserve Memo," with the stated purpose "to obtain sufficient and appropriate evidence regarding the appropriateness of the client's Repurchase Reserve calculation," which Kim reviewed and initialed. New Century's repurchase reserve calculation for the third quarter 2006 is presented in a box on the front page of that memorandum. The calculation presented includes only "Estimated Premium to be Refunded to Investor" and "Estimated Lost Interest to be Refunded" and contains no severity component, either for losses on repurchased loans in LHFS (Inventory Severity) or for losses on future repurchases (Future Loss Severity). This is consistent with the advice Kim gave Sanchez. The KPMG memorandum concludes, contrary to GAAP, that New Century's "calculation appears appropriate as a method of estimating the Company's repurchase reserve liability."

The memorandum discusses two changes New Century made to its repurchase reserve calculation in the third quarter. First, the Company used more recent history to determine its percentage of whole loan sales historically repurchased, and second, as discussed above, the Company added Interest Recapture. The memorandum made only a passing reference, however, to the removal of the critical component, Future Loss Severity, from the Company's calculation. The KPMG memorandum noted that, although the Estimated Losses on Future Repurchases component had previously included Future Loss Severity, it was now comprised solely of Premium and Interest Recapture. The memorandum noted that the reason for the change was that the "former method was essentially an adjustment that is accounted for in the Company's LOCOM adjustment."

Most KPMG witnesses interviewed by the Examiner attempted to distance themselves from this memorandum. Kim's initials appear on the memorandum, and he conceded reviewing it and participating in its preparation. Kim said that Donovan also participated in discussions with him and the junior auditor who wrote the memorandum regarding the third quarter changes,

as well as discussions related to the need for a memorandum and the substance of the memorandum. Donovan, however, claimed that he did not see the memorandum and was unaware of the third quarter 2006 changes. As a result of the possible restatement in early 2007, KPMG assigned Kurtis Kurimsky, a partner with KPMG's DPP, to conduct a "desk review" of KPMG's workpapers to determine if any additional issues required attention. In addition, Marc Macaulay, KPMG's SEC concurring partner on the New Century engagement, conducted an "in-depth review" of KPMG's workpapers to determine whether any of KPMG's conclusions were inappropriate. Despite conducting their respective reviews specifically as a result of a possible restatement relating to New Century's repurchase reserve, neither Kurimsky nor Macaulay could recall whether they had ever seen the third quarter Repurchase Reserve Memo. The Examiner does not find Donovan, Kurimsky or Macaulay credible in this regard.

Kim's recommendation to New Century to remove Future Loss Severity directly contravened GAAP, as stated in paragraph 55 of FAS 140. KPMG's subsequent third quarter 2006 review then failed to identify the material departure from GAAP in that it failed to recognize that Management's calculation of the repurchase reserve did not consider any loss severity. With respect to its third quarter review, KPMG failed to conduct adequate analytical procedures, inquiries, and other procedures to address whether the accounting estimate was reasonable and presented in conformity with applicable accounting principles. KPMG actually took an active role in providing erroneous advice to Management relating to the proper GAAP treatment for a key account, and, in doing so, breached the standard of due care.[689] For the second consecutive quarter, at a time when market conditions and New Century's own experience indicated a need for greater reserves, KPMG departed from taking a conservative approach and in fact recommended that New Century make a change to its repurchase reserve calculation that had the effect of *decreasing* the reserve.

e. KPMG Concluded That New Century's Application of LOCOM Was Consistent with GAAP Although Repurchased Loans Were Improperly Priced and It Operated To Conceal Losses.

The Examiner identified two issues with respect to New Century's application of the LOCOM requirements of FAS 65. First, as described previously, prior to the second quarter of 2006, New Century calculated a LOCOM adjustment for repurchased loans included in LHFS as

[689] AU §§ 230 and 722.

part of the repurchase reserve calculation, but reported this amount on its balance sheet as part of LHFS in the LOCOM valuation account. The Examiner determined that the prices (or marks) that New Century used to value repurchased loans in the fourth quarter of 2005 and first quarter of 2006 were not consistent with the marks used in its LOCOM analysis for its LHFS portfolio. In addition, starting in the second quarter of 2006, New Century eliminated entirely this LOCOM adjustment for repurchased loans. As a result of this misapplication of LOCOM for repurchased loans included in LHFS, the LHFS portfolio was overstated in the Company's financial statements by at least $9.8 million for the year-ended December 31, 2005 and by at least $18.4 million, $81.9 million and $85.8 million in the first three quarters of 2006.

Second, the Examiner found that New Century did not apply LOCOM in a manner consistent with industry practice, thereby enabling the Company to conceal losses in its LHFS portfolio by offsetting losses in certain loan categories with gains in other loan categories. In applying LOCOM, New Century first determined the market value of LHFS separated by loan categories related to risk and loss. However, it then collapsed those separate categories and re-aggregated the entire pool of LHFS for LOCOM purposes. As a consequence, loan losses in some categories, such as non-performing loans, were offset by gains in other categories. By utilizing this practice, New Century Management consistently determined that a LOCOM adjustment was not required and that it did not have to mark down the value of the "scratch and dent" and other non-performing loans. The Examiner believes the practice of re-aggregating loans into a single category after the loans were priced, and using gains to offset losses, is inconsistent with industry practice in applying and interpreting FAS 65. As a result of this misapplication of LOCOM, the LHFS portfolio was overstated in the Company's financial statements by at least $3.1 million for the year ended December 31, 2005, and by at least $3.9 million, $20.5 million and $30.6 million, respectively, in the first three quarters of 2006.[690]

In its 2005 audit and 2006 quarterly reviews, KPMG examined New Century's LOCOM analysis and determined that it was reasonable. When questioned about this practice by the Examiner, Kim and Donovan both stated that the practice was acceptable because it was technically permitted under FAS 65. This conclusion does not evidence proper consideration of

[690] These amounts relate to New Century's application of LOCOM in a manner inconsistent with industry practice. The Examiner does not consider these amounts misstatements because the application of the LOCOM requirements pursuant to FAS 65 is subject to varying interpretations.

industry practice or the overall impact of the accounting treatment on the financial statements presented.[691]

Minimal research and analysis by the KPMG engagement team would have revealed that New Century's LOCOM analysis was not only contrary to industry practice, but that it operated to conceal losses and prevent the mark-down of the value of non-performing repurchased loans. KPMG's failure to recognize this valuation issue evidences a lack of due care in performing the audit and reviews. Moreover, as a result of this failure, KPMG did not properly advise Management or the Audit Committee that: (1) New Century's LOCOM analysis was not consistent with industry practice; (2) the practice had the potential to conceal losses; and (3) the practice actually did cause New Century to conceal losses and overstate the LHFS balance.

f. KPMG Did Not Detect Material Weaknesses in New Century's Internal Controls Regarding Repurchase Reserves.

During the 2004 SOX audit, KPMG concluded that New Century lacked written policies and procedures for estimating the repurchase reserve. In 2005, despite the Company's failure to develop and implement a formal policy for the second year in a row, KPMG concluded that this deficiency was not significant. In support of its assessment, KPMG cited in its workpapers to its materiality thresholds. When interviewed by the Examiner, the KPMG auditor responsible for most of the 2005 internal control audit work stated that KPMG's detailed quarterly reviews of the repurchase reserve allowed it to observe and test the control points of New Century's process for calculating the repurchase reserve irrespective of whether the policy was formally adopted. However, as discussed above, KPMG failed to appreciate the effect of changes in the methodology for calculating the reserve, and it failed to detect a material weakness relating to the backlog of repurchase claims. A formal corporate policy setting forth the required procedures for calculating the repurchase reserve in sufficient detail likely would have alerted KPMG to both of these issues.

Despite its status as a significant financial account, KPMG's SOX walkthrough of New Century's repurchase reserve estimation process in 2004 and 2005 failed to detect the lack of effective controls relating to the communication of repurchase requests from New Century's Secondary Marketing Department to the Accounting Department. The Accounting Department was responsible for calculating the reserve, yet no procedures existed in either the Accounting

[691] AU §§ 230, 342 and 722.

Department or Secondary Marketing for communication between the two departments of anything other than actual repurchases made. KPMG's SOX walkthrough should have revealed this lack of communication. Indeed, as a result, New Century's repurchase reserve methodology only took into consideration repurchases actually made, and not repurchase requests received. KPMG's internal control review was equally deficient because it started its review with repurchases actually made instead of beginning at the time when repurchase requests were first received. As a result, KPMG missed the growing backlog of repurchase claims that should have been properly included as part of the repurchase reserve calculation methodology. KPMG should not have issued an unqualified opinion on the adequacy of New Century's internal controls in light of this glaring disconnect between the two departments primarily responsible for this significant financial account.

During the 2004 year-end audit, KPMG noted that the principal balance of loans repurchased in the fourth quarter of 2004 soared to $58.7 million as compared with $22.8 million in the prior quarter. KPMG workpapers note that "the bulk of Q4 2004 repurchases took place in November 2004." Some of the increase was attributed by KPMG to the repurchase of "a bulk of loans from Morgan Stanley due to first payment default." KPMG's workpapers do not indicate that any other follow-up or substantive testing was performed to confirm this response or calculate the impact on the applicable accounts. An internal New Century communication from Cloyd to Walker noted that the increase was due, in part, to the fact that "many of the loans repurchased were from prior quarters and months leading to the increased volume and discount." It is not clear whether this information was conveyed to KPMG, but it likely was conveyed because KPMG had specifically inquired regarding the November 2004 repurchase spike. In any event, KPMG's lack of diligence during the SOX 404 audit process failed to detect the fact that as early as 2004, repurchase claims were rolling over from one quarter to the next. As a result, KPMG and New Century missed an important opportunity to identify this material weakness in the repurchase claims process at a time when KPMG was on notice of the issue.

As a result of the material weakness with respect to New Century's repurchase reserve calculation process, KPMG's unqualified opinion in 2005 on the adequacy of New Century's internal controls over financial reporting violated AS 2. In addition, KPMG violated AS 2 by not informing the Audit Committee of the material weakness.

Moreover, although no opinion was issued by KPMG with respect to the 2006 SOX 404 audit, the Examiner believes that the SOX 404 audit was substantially completed by KPMG by the time the firm resigned in April 2007. Based on the Examiner's review of the workpapers in connection with the repurchase reserve process walk-through for the 2006 SOX 404 audit, it appears that the second and third quarter changes to the repurchase reserve calculation methodology escaped engagement team scrutiny. These changes, as discussed above, not only violated GAAP, but also had the effect of decreasing the reserve at a time when all market conditions suggested the reserve should be increased substantially. Because there was no formal accounting policy regarding the repurchase reserve calculation—which had been deemed to be an insignificant control weakness by KPMG in prior audits—Management had unfettered discretion over changes to the reserve calculation, and the Audit Committee was never informed of these changes.

3. KPMG's Reviews and Audits of New Century's Residual Interest Valuations Did Not Reflect Due Care.

In its annual audit planning documents for 2005 and 2006, KPMG identified New Century's residual interest valuations, like the repurchase reserve, as a critical accounting policy, which reflected KPMG's judgment that it was "both most important to the portrayal of the company's financial condition . . . and require[d] management's most difficult, subjective or complex judgments . . . ." Nonetheless, KPMG failed to detect the material overstatement of the value of the Company's residual interests in the 2005 year-end financial statements and in its 2006 interim financial statements. Indeed, KPMG consistently concluded—and represented to the Company's Audit Committee—that the Company's residual interest valuations were reasonable and KPMG issued an unqualified audit opinion on the 2005 year-end financial statements.

GAAS, as described above, requires independent auditors to exercise due care in the planning and performance of an audit. The Examiner finds that KPMG failed in its duties. An extensive chronology of KPMG's conduct is contained in Section VI.B., and will not be repeated here. A discussion of the pertinent factual findings in light of the relevant standards is set forth below.

a. KPMG Failed to Plan Its Audits and Reviews of New Century's Residual Interest Valuations Effectively in Light of Noted Deficiencies in Internal Controls.

In 2004, 2005 and 2006, KPMG identified a number of internal controls deficiencies with respect to the residual interest valuation process. As discussed in greater detail in Section VIII., during its 2004 internal control review, KPMG documented a significant deficiency in internal controls surrounding residual interests, noting that New Century did not have adequate documentation supporting its valuation of residual interests. Specifically, KPMG concluded:

> Management neglected to create adequate documentation supporting data inputs for Secondary Marketing's calculation of residual values and the loss curves used in determining the allowance for loan losses. This includes collateral data reconciliation and certification of expected cash flows. This information is necessary to support the review process of such calculations to help ensure data integrity underlying the calculations.

KPMG reported this as a ***significant deficiency*** to New Century in its year-end management letter. KPMG's 2004 workpapers indicate that the Company remediated this deficiency as ofyear-endbased on KPMG's review of the minutes of a REIT Committee meeting in late January 2005 at which the topic of residual interest valuations was discussed. Not only did the REIT Committee meeting occur after year end, but the documentation provided does not appear to have addressed the specific concerns underlying the deficiency finding.

In 2005, KPMG also identified thirteen control deficiencies relating to the residual interest valuation process. Notably, the identified deficiencies included concerns relating to missing policies, support for assumptions and documentation. Similarly, KPMG's draft workpapers for its 2006 SOX 404 audit noted a number of deficiencies related to residual interest valuation, including the recurring theme that "[m]anagement does not have a regular, documented process in place to determine a threshold at which to adjust assumptions in the residual asset models."

Despite the identification of significant internal control deficiencies with respect to residual interests in the 2004 SOX 404 audit, this area of the engagement was assessed a risk of misstatement of "moderate" for 2005. Moreover, while the audit risk in this area was changed to "high" in 2006, the Examiner has not been able to discern any significant difference in the planned tests for 2006.

GAAS requires independent auditors to develop a plan for their audit that is appropriate in light of relevant facts and circumstances. KPMG's planned audit procedures in 2005 and 2006 with regard to residual interest valuation issues, and its documentation in underlying workpapers, were insufficient to address the increased risk related to internal control deficiencies in key process areas that either were or should have been identified by KPMG. Moreover, as discussed further below, KPMG should have considered the known deficiencies in internal controls when testing (or relying on) Management's assumptions and representations.

b. KPMG's Acceptance of Management's Assumptions Was Unreasonable.

The assumptions underlying Management's residual interest valuations were accepted as reasonable by KPMG in the absence of sufficient evidence to support those assumptions. In light of the lack of internal controls surrounding residual interest valuation, and, in particular, a lack of documentation to support the assumptions, KPMG did not exercise appropriate professional skepticism in conducting its audits and reviews. Applicable professional auditing standards required KPMG to adopt "an attitude that includes a questioning mind and a critical assessment of the audit evidence," or to obtain sufficient evidence to support Management's assumptions. KPMG's acceptance of Management's assumptions without supporting evidence represents a clear departure from GAAS and a lack of professional care.[692]

i. Discount Rates

First, as discussed in Section VI.B., the Examiner has concluded that the discount rates used by New Century in calculating the value of its residual interests were too low as of year-end 2005 and through the first three quarters of 2006. Specifically, the Examiner has concluded that the discount rates should have been no less than 15% and 17%, respectively, for the CE securitizations and NIMS as of year-end 2005 and that New Century's financial statements overstated the value of the Company's residual interests for that period by at least $14.8 million because it relied upon unduly low discount rates of 12% and 14%. KPMG effectively approved New Century's discount rates despite clear indications that they were not appropriate from, among others, KPMG's own internal SFG specialists.

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[692] The use of marketplace information, where appropriate, is required by GAAS. AU § 326, ¶ 6 ("However, if observable market prices are not available, GAAP requires that valuation methods incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost or effort.").

As early as the first quarter of 2005, KPMG knew that the Company's discount rates were aggressive. Indeed, each SFG review revealed this fact, quarter after quarter. Specifically, the audit assist memoranda Carnahan prepared in the first three quarters of 2005 stated that New Century's discount rate "is at the low end of the range compared to similar issuers" with "other issuers . . . typically using residual asset discount rates principally ranging from 12% to 35%." SFG recommended that the engagement team obtain from New Century information supporting the use of its relatively low discount rates, such as a letter from an investment bank or market information for a comparable asset. Despite SFG's findings, the engagement team repeatedly concluded that the residual interest valuations were reasonable and proper, without insisting, during its quarterly reviews, on the documentation that the SFG had recommended.

New Century ultimately provided supporting documentation to KPMG in January 2006 in connection with the 2005 audit. Although the engagement team determined that the discount rates were reasonable based on this documentation, the SFG considered the Company's documentation to be insufficient because New Century provided comparative market data for various bonds and had concluded that a corporate junk bond supported its low discount rates. SFG did not view this as an appropriate comparison. Moreover, SFG expressed increasing concern that the Company's discount rates were inconsistent with rates used in comparable sales of residual interests by New Century's peers. For example, in an e-mail dated February 14, 2006, Carnahan noted that "[w]e have numerous clients that have sold Residuals in the last year and the average discount rate . . . has been 18% to 23%" for non-NIMS and two other clients use rates of 35% and 40% for NIMS . . . . ***[T]his client [New Century] has the lowest sub-prime Residual discount rates of any client that I am aware of, which we have consistently communicated.***" (emphasis added) Nonetheless, less than two months later, the KPMG engagement team's conclusion memorandum states, as it had stated for the previous quarters: "Given the Company is in sub-prime lending, the assumed discount rates appear reasonable . . . ." Whether due to a lack of understanding, unreasonable reliance on Management or a lack of willingness to challenge Management in the wake of the 2005 10-K filing crisis, the engagement team merely reiterated its client's rationale instead of properly considering the contrary data presented by SFG.

In the fall of 2006, the SFG eventually pushed even harder for stronger documentation of the Company's discount rates, at which time Dodge and Kenneally asked Goldberg to prepare an

analysis of these discount rates. Goldberg's analysis concluded, and Kenneally and Dodge agreed, that the Company should recommend an increase of the residual interest discount rates to 15%. Although Carnahan wanted to press for at least market bids to support the valuations, KPMG did not press the Company for such bids nor did KPMG press Management or the Board to increase the discount rate. The Finance Committee of the Board ultimately rejected that recommendation on October 16, 2006. Details regarding this series of events are set forth in Section VI.B.

When questioned by the Examiner, both Donovan and Kim reiterated their belief that the Company's residual interest discount rates were appropriate during this time period, despite SFG's concerns, and maintained that SFG ultimately agreed that the Company's residual interest valuations were reasonable. Carnahan supported that view, but the Examiner finds that the plain language of the SFG memoranda—and the increasing alarm noted in the memoranda—are inconsistent with his representations to the Examiner. This is yet another area in which the KPMG witnesses did not appear credible.

ii. Par Value Assumption

The Examiner also is critical of New Century's unquestioning reliance upon its assumption that remaining loans would be sold at par upon collapse of a securitization. The Examiner has not found any evidence, however, that KPMG challenged New Century's reliance upon this "par value" assumption throughout 2004, 2005 and 2006. In determining that the par value assumption was reasonable, KPMG appears to have relied only on information obtained from the Company that the remaining loans in a small number of older deals had been sold "at about par" when those deals collapsed, claiming that "the Company has enough internal historical data of its own in order to evaluate the reasonableness of assumptions." New Century departed from the par value assumption on its own initiative in February 2007.

The par value assumption was embedded in all of the Company's many residual interest valuation models, including the models that the SFG reviewed each quarter. At a minimum, KPMG's engagement team should have challenged this assumption as early as 2005 by requesting that New Century provide documentation that would explain and support its reliance upon the par value assumption. Such a challenge might have triggered the kind of analysis that John Hatch ultimately conducted in the fall of 2006 and the kind of discussion New Century

engaged in during consideration of Project Kettlebell, which ultimately led the Company to realize the problems with the par value assumption.

iii. Prepayment Rates

Management's prepayment rate assumptions were based on historical information—the average performance of New Century's loan collateral from 1997 to 2002—that did not yield accurate estimates. The Examiner has concluded that the Company should have been calibrating the prepayment assumptions in its residual interest valuation models to reflect changing market conditions much earlier than 2007.

KPMG's SFG consistently recommended that the KPMG engagement team analyze New Century's prepayment assumptions because the Company's prepayment assumptions were considered "low compared to those of similar issuers, the prepayment performance in the industry, and the Pool's historical performance." As discussed above, SFG also recommended that New Century update these assumptions because New Century's actual prepayment results repeatedly differed from its projected results, but the engagement team did not press this point and New Century did not adjust its assumptions until February 2007. The engagement team's conduct with regard to this critical assumption in New Century's residual interest valuation models is further evidence of a lack of due professional care.[693]

iv. Clean-up Call Percentages

KPMG's SFG was concerned about the Company's practice of routinely changing the clean-up call percentages in its residual interest models, which effectively pushed out the clean-up call dates. As a result, the SFG recommended that the engagement team test the Company's assertion that it would terminate securitizations when they reached the clean-up call percentages specified in its residual interest valuation models and obtain explanations when the clean-up call percentages differed from quarter to quarter. The SFG noted that changing a clean-up call to a lower percentage effectively pushed out the terminal cash flows associated with the Company's residual interests and tended to increase their fair value.

During its first quarter 2006 review, KPMG learned that projected cash flows in the residual interest valuation models were higher than actual cash flows by $3 million (which amounted to roughly 10% of the value). In its workpapers, however, KPMG concluded that this

[693] Since the first quarter of 2005, SFG had recommended that the engagement team analyze the prepayment assumptions and had repeatedly raised the issue that New Century's prepayment rate was low compared to the rates of similar companies, industry prepayment performance, and historical prepayments.

"slight" 10% variance "indicates that the residual interests appear reasonable." KPMG apparently did not evaluate the significance of that difference and its impact on the Company's financial statements, however. The Examiner was told by Ryan Beckstrom that no such analysis was conducted because this difference was discovered as part of a quarterly procedure. The Examiner finds that KPMG should have explored further the cause of the variation and its impact before concluding that the valuation was reasonable..

In addition, although members of the engagement team and SFG recognized potential problems with New Century's changes in its clean-up call percentages, the engagement team was not aggressive enough in determining the causes of those changes and in communicating their significance to Licata and other appropriate people at New Century.

In sum, the Examiner finds that, particularly with respect to the discount rate and par value assumptions, KPMG's engagement team should have questioned Management and, in general, exhibited a far greater degree of professional skepticism with respect to the Company's assumptions by, for example, including demanding more evidence to support those assumptions. In addition, KPMG's workpapers and the Examiner's interviews indicate that members of the engagement team believed that Management was not reviewing the validity of its own assumptions for pre-2003 securitizations as of at least late 2005.[694] Such a belief should have triggered further inquiry of Management, at minimum, to determine why they were no longer updating the assumptions and follow-up testing to determine whether the assumptions were adequate. Moreover, while Kim told the Examiner that he reviewed Finance Committee minutes as a matter of course to determine Management's changes to its assumptions, the Examiner has not found, with the exception of the October 2006 discussion of the discount rate, anything more than passing references in the Finance Committee minutes to the assumptions, and the minutes certainly do not provide comfort that a system was in place for reviewing the assumptions or that sufficient documentation existed to support the assumptions.

c. KPMG Did Not Question Reliability of the Company's Models.

The Examiner believes KPMG should have been more critical of estimates generated by models developed in-house. Indeed, auditing standards recognize that externally derived evidence (*e.g.*, reliance on a model developed by a third party to support a company's estimates)

[694] While the Examiner found that changes actually were made through the first quarter of 2006, New Century began to drastically reduce the number of assumption changes made to the pre-2003 models in late 2005.

is generally more reliable than that obtained solely from sources inside the company (*e.g.*, in-house models).[695] Although Kim and Donovan claim that many clients in the industry developed their own models, the Examiner finds that, by 2005, that was not the case. As set forth in Section VI.B., the Examiner has concluded that the models used by New Century to calculate the value of its residual interests should have been abandoned by 2006, at the latest, in favor of third-party models, which were widely used in the industry at that time.

Moreover, as discussed in Section VI.B. and as summarized below, KPMG personnel knew that the models used by Management to calculate residual interest valuations were flawed and had generated errors. The reliability of the models was repeatedly called into question. In its audits and reviews of New Century's residual interest valuations, KPMG determined on a number of occasions that the models contained errors. In early 2006, an error caused by the failure to include private mortgage insurance in one of the 2005 securitization models was deemed to be significant and required a $9 million write-down. The error, which existed at December 31, 2005 and which overstated the value of the Company's reported residual interest assets, was detected by SFG in its testing of a sample of models in the first quarter of 2006.

The engagement team also discovered variances between the data inputs in several models and comparable data from the corresponding trustee statements, which, it was told by Mullins, were due to minor flaws in the models. Beckstrom, the junior auditor responsible for reviewing residual interest valuations, did not recall what, if anything, was done to verify that the variances were a result of minor flaws in the models nor did he recall whether anyone tried to quantify what the variances might have been or whether there was a need to make an adjustment to the models as a result. When Beckstrom reviewed the workpapers for the 2004 year-end audit (as part of his work on the review for the first quarter of 2005), he found that discrepancies had been identified in models as part of the 2004 year-end audit work as well. These variances were documented in the workpapers, which should have been reviewed by the engagement manager and audit partner.

Other KPMG engagement team members also acknowledged the existence of modeling errors during their interviews with the Examiner. Donovan and Kim said they knew of the flaws, but claimed that they were immaterial, even in the aggregate, even though they reached their conclusions without any documentation as required by AS 3. Moreover, KPMG's approach –

[695] AU § 326.21.

and the views of its engagement team – apparently did not change despite the discovery of the $9 million overstatement by one model in the fourth quarter of 2005. Even when interviewed, Kim and Donovan claimed that the models were sufficient.

An analysis conducted by PwC in early 2007 of models for two 2005 securitizations confirms that the models were deficient in numerous respects, including that:

- The loss calculations were inconsistent with industry practice.
- The delinquency triggers were not modeled appropriately.
- The discount rates used for valuation were not product-specific, while New Century's pricing model had product-specific discount rate adjustments.
- The models were limited to 20 rep lines – limiting the models' granularity.
- The processes for regular review and updates to model assumptions were not defined.
- There was no model documentation.
- A significant key person risk existed, which was exacerbated by the limited documentation and use of a propriety model.
- No controls existed for model changes.[696]

The Examiner finds that, had KPMG exercised appropriate professional skepticism with respect to the reliability of the models and conducted more rigorous testing (instead of relying solely on Management's representations that variances were caused by "minor flaws"), these deficiencies would have been discovered much earlier. That KPMG never challenged the continued use of the internally developed models is yet another example of a lack of professional skepticism exhibited by the engagement team[697] and a failure of the team to obtain sufficient and competent evidence to support a valuation estimate.[698] This failure is particularly notable given that, several years before, with respect to New Century's financial statements for the year ended December 31, 2000, KPMG discovered a calculation error in the residual interest models that led to a $70 million write-down that resulted in the first loss in New Century's history.

[696] This analysis was pursuant to an engagement of PwC by Taj Bindra that was separate and independent of the work later down by PwC in connection with the SIC's investigation.

[697] AU § 230

[698] AU § 326

4. KPMG's Reviews and Audits of Other Financial Accounts Also Reflect a Lack of Due Care.

The Examiner's investigation also revealed other errors in New Century's financial statements, as discussed above, and corresponding audit and quarterly review failures by KPMG. While the Examiner is not in a position to conclude whether these errors caused a material misstatement, they nonetheless reflect, at best, a lack of professional skepticism and due care in KPMG's audits and reviews and, at worst, an acquiescence by KPMG in New Century's aggressive accounting policies and practices.

a. Allowance for Loan Losses

New Century established an ALL to reserve for losses related to its on-balance sheet loans held for investment ("LHFI") and related assets. LHFI included securitized loans structured as financings and those loans pending securitization as financings. Loans securitized as financings do not qualify for sales treatment under FAS 140 and therefore were retained on the Company's balance sheet.

KPMG's workpapers indicate that New Century's ALL estimation models were reviewed during the quarterly reviews and year-end audits during 2004 through 2006. KPMG identified the ALL calculations as a risk in their planning documents for 2004, 2005 and 2006. In all three years, the ALL was identified as a critical accounting policy. [699] Beckstrom was the primary engagement team member performing the work on the ALL in 2005 and 2006. KPMG applied analytical procedures, inquired of Management, and tied out actual data from the ALL models prepared by New Century to the underlying trustee statements for the securitizations in performing its audit and review of ALL.

Based on the Examiner's review, and the fact that KPMG assigned some risk to ALL calculations year over year, the Examiner has concluded that KPMG's review and audit of ALL did not comport with applicable professional standards. KPMG commented at various times in 2004 through 2006, in both the general audit workpapers and those related to internal controls over financial reporting, that the Company did not adequately document its methodology for its ALL, and yet KPMG allowed the same deficiencies to remain unremediated each year. Additionally, the assumptions used to estimate the ALL were not updated for the trends in actual performance or Management's revised expectations. KPMG failed to insist that New Century

[699] Form 10-K for 2005 at pp. 63-64.

update the models that KPMG knew were incorrect and which resulted in inaccurate amounts for the ALL. KPMG's failures likely violated its obligation to use due care and exercise professional skepticism in accordance with AU § 230. Additionally, KPMG failed to obtain sufficient evidence and improperly relied on assertions of Management regarding ALL estimates in violation of AU §§ 326 and 342. Finally, KPMG also did not modify its audit plan appropriately in light of the circumstances identified by KPMG as affecting ALL calculations for 2004 and 2005.

Lack of documentation for the ALL estimation was identified as an issue for New Century as early as 2004. On March 15, 2005, KPMG sent a letter to Dodge regarding the 2004 audit of internal controls over financial reporting. The letter identified the following significant deficiencies with the ALL: (i) Management's failure to create adequate documentation evidencing the appropriate application of GAAP to ALL; and (ii) Management's lack of adequate documentation to support the loss curves used in determining ALL.

Despite its identification by KPMG during the 2004 audit, New Century's lack of documentation to support the loss curves was not listed in the substantive audit procedures until 2006 when it was listed as a control risk. It also was included as a deficiency in KPMG's workpapers for the incomplete 2006 audit along with a statement that, "[p]olicies and procedures to describe the Allowance for Loan Loss (ALL) methodology are not formally documented." When interviewed by the Examiner, Kim could not explain why the significant deficiencies documented in the letter to Dodge in March 2005 had not been remedied as of year-end 2006 or why they were not viewed as a significant deficiency during the 2005 SOX 404 audit.

In 2006, based on the heightened risk of the ALL noted in the planning documents and the Audit Committee's increased interest in the adequacy of the ALL, a specialist in FRM conducted an audit assist at the request of the engagement team and performed a detailed review of the modeling approach and forecasting outputs generated by the Company in preparing its ALL. The specialist drafted a memorandum dated December 2006 wherein he concluded that, with respect to ALL: "[t]here is no model development documentation;" "[t]here have apparently been no formal model validations performed over the net loss forecasting methodology;" "[t]here is no documentation describing Allowance for Loan Loss procedures;" and the Company lacked documentation to support the "development and modification of the allowance for loan losses base curve." Both Kim and Donovan were interviewed regarding the specialist's comments.

Kim reported that the Company was looking into the matters brought to light by the specialists. Donovan stated that the Company actually had the necessary documentation and that during the spring of 2007, it was in the process of gathering the data to give to KPMG.

The Examiner found no evidence that New Century provided KPMG with the missing ALL documentation identified by the specialist from 2004 through 2006. Substantially similar deficiencies were noted at several points over the three-year period and there is no evidence that these deficiencies were remediated. The substantive guidance in the area of ALL contained in SAB 102 and FRR 28 focuses predominantly on the necessity for documenting the Company's support for the amount and methodology of estimating the ALL. There is no evidence for the years 2004 through 2006 that New Century had such documentation or that KPMG tested for remediation and documented the results in its workpapers.

New Century's modeled ALL estimates produced different results than the actual loan losses in virtually every quarter. In quarterly and year-end workpapers from 2005 to 2006, KPMG documented that the ALL was overreserved based on the rolling 18-month projection used to estimate the ALL. The 2005 through second quarter 2006 workpapers for the ALL state that:

> The Company believes that the model reasonably supports the above balance as expected losses for some of its earlier models have been lower than initially modeled and thus the allowance has not been reduced by expected charge-offs. The Company believes that the actual losses may exceed the modeled losses in future periods and does not believe it appropriate to reduce the allowance in the [current quarter] due to what could possibly be timing differences or a period of unusual actual losses.

In the third quarter of 2006, the language changed slightly:

> KPMG obtained the eighteen models for the pools above and noted that the expected losses are set on a base curve that has historically projected greater losses than have been experienced, and these base curves continue to project greater losses than the historical curve would indicate. Per discussion with Management, this difference is the result of changes in the economic environment, such that historical losses may not accurately predict future losses given the slowing housing market and decreasing appreciation on home prices in many markets.

The 2006 year-end workpapers reflect that New Century's ALL "had been overaccrued in the past and now the seasoning of the portfolio [caused] actual losses to approach the level of expected losses."

For each of these quarters, although the workpapers indicate that Management knew the performance of the loan portfolios differed significantly from the ALL methodology, KPMG never sought to revise the calculation or quantify the potential misstatement. The Company's estimate in June 2006 was that the ALL was overreserved by $21 million.

The provision for loan losses is primarily governed by FAS 5, which allows a reserve for an estimated loss to be recorded (1) when it is probable that an asset has been impaired (or a liability has been incurred) *and* (2) the amount of the loss can be reasonably estimated. The fact that Management's estimation of the ALL was inconsistent with actual losses indicates that Management may have maintained an overstated ALL through 2004 and 2005 to cover future losses that were not "probable and estimable," as required by FAS 5. As noted, KPMG declined to challenge Management's assumptions regarding the ALL or quantify the potential overstatement of this reserve account.

b. Mortgage Servicing Rights

Although New Century sold (through either whole loan sales or securitizations) a large number of the loans it originated, it continued to hold the right to service many of these loans, i.e., mortgage servicing rights ("MSRs"). FAS 140 provides the relevant guidance regarding the accounting for MSRs, and requires that the retained interests in the transferred assets be measured by allocating the previous carrying amount of the loans transferred between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer. It also requires that servicing assets and liabilities be (a) amortized to income or expense in proportion to and over the period of estimated net servicing income or loss and (b) assessed for impairment (or increased obligation) based on their fair values. Under FAS 140, a company is required to disclose its accounting policies for initially measuring the MSRs, including the methodology used in determining their fair value and the key assumptions used in measuring the fair value of the MSRs at the time of securitization.

New Century improperly recorded the initial values of its MSRs by using estimates of market value, as opposed to allocating the carrying amount of the loans transferred between the assets sold and the interests retained, as required by FAS 140.[700] As a result, although the

[700] For the 2005 audit, KPMG quantified the impact of this deviation from GAAP, and determined that the resulting figure ($698,217) fell below the posting threshold from the Company's income statement. KPMG's engagement team does not, however, appear to have recommended that the Company alter its method of recording initial MSR

Company claimed in its public disclosures that it conducted a quarterly impairment assessment of its MSRs, New Century *could not* have meaningfully undertaken that analysis in light of its failure to book the initial values of these assets appropriately.

In connection with the 2005 audit, KPMG observed that New Century did not perform a formal valuation of its MSRs portfolio (relying instead upon quoted market prices on historical transactions to estimate the fair value of its MSRs). KPMG's SFG recommended in February of 2006 that the Company obtain at least one independent, third-party valuation to support its internal valuation, but there is no indication that the KPMG engagement team pressed this recommendation with New Century. Further, New Century did not conduct a formal valuation of its ongoing servicing operations, which created the possibility of a GAAP violation, as FAS 140 requires all institutions conducting loan sales and securitizations to perform ongoing valuations of their servicing portfolios, including amortization and impairment analysis.

To the extent that the Company attempted to amortize the net gains or losses from its MSRs, it did so using a simple, linear approach. This violates the requirement of FAS 140 that a net proportional amortization method be used for this purpose.[701] KPMG was aware of this departure from FAS 140, which was mentioned in a draft audit assistance memorandum from SFG relating to the 2005 audit.[702] In addition, that same draft contained a comment inquiring about the quantitative impact of this improper amortization method and raising the possibility of an audit difference. It does not appear that KPMG or the Company ever calculated that impact.

Nonetheless, the Company represented (inaccurately) in its 2005 financial statements that its accounting for MSRs complied with GAAP. KPMG's awareness of potential GAAP shortfalls outlined above, and its failure to quantify their impact, reflect a lack of due professional care. At a minimum, consistent with its obligations under applicable professional standards, KPMG should have conducted additional inquiry and testing to determine the impact of the GAAP violations. Its failure to do so was inconsistent with GAAS.[703]

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values to comply with FAS 140, nor did KPMG quantify the impact of this non-GAAP practice in other accounting periods.

[701] Under the net proportional method, a higher degree of amortization occurs during more pronounced periods of expected income or loss, while less amortization occurs in periods of lower projected gain/loss.

[702] Mention of this issue was removed from the final version of the memorandum.

[703] *See, e.g.*, AU § 230 (due care).

c. Deferral and Amortization of Loan Origination Fees and Costs Under FAS 91

New Century was required to defer its costs and fees associated with the origination of mortgage loans in accordance with FAS 91. KPMG performed year-end audits and quarterly review of the FAS 91 calculations from 2004 through 2006. Generally, a staff accountant performed the work, a senior associate supervised it and the manager and partner reviewed the work. In each quarterly review and year-end audit from 2004 through 2006, KPMG determined that New Century was accounting for loan origination fees and costs in accordance with FAS 91. Additionally, KPMG workpapers reflect that the procedures performed by KPMG essentially did not change over this entire period.

In order to calculate the amortization under FAS 91 for New Century, certain net costs were pooled and allocated pro rata because New Century was unable to capture loan level information and direct origination costs on each individual loan. The net costs were then divided by the number of loans for the given period to derive the costs per loan that should be allocated under FAS 91 and the costs were applied to unsold inventory. The computations were passed to the Accounting Department at New Century to perform the amortization calculations.

i. Risk Assessment

KPMG assessed the RoSM of net deferred origination costs as "low" in 2004 and 2005 and "moderate" in 2006. In addition to altering the risk assessment, KPMG changed its 2006 audit procedures to review New Century's amortization methodology. The 2006 planning document states that KPMG should take steps to ensure that current expenses are not being deferred in FAS 91 type activities. The 2006 planning document also identified amortization of origination costs as a fraud risk.

Kim told the Examiner that the RoSM was assessed as low in 2004 and 2005 because the amortization of deferred origination costs was routine, in spite of the fact that variable assumptions such as prepayment speeds could affect the calculation. Neither Donovan, Macaulay nor Kim were able to provide any explanation regarding the change in assessment from 2004 and 2005 to 2006. In addition, they were unable to explain the fraud risk.

According to the workpapers, moderate risk was assigned by KPMG in 2006 because the Company did not amortize deferred origination costs on a loan level basis and there was a risk of inaccurate amortization when applying the pool method. Macaulay opined that errors, rather than fraud, could arise because of the amortization on a pool basis. However, New Century

amortized these fees and costs on a pooled basis for the entire time period from 2004 through 2006, so it is unclear why the inherent risks associated with pool-based amortization affected KPMG's risk assessment of the FAS 91 calculation only in 2006. To the extent that this was not understood to be a risk in the prior years suggests that KPMG did not exercise reasonable care and diligence in its assessment of the risks involved in the FAS 91 calculation in 2004 and 2005 and that the audits and reviews were not planned appropriately as a result.[704]

ii. Errors Detected

In the third quarter of 2004, the Company changed its practices with respect to correspondent loans and began to exclude commissions paid to New Century employees in obtaining correspondent loans in the calculation of the deferred cost balance. New Century continued this practice until the second quarter of 2006, when it was discovered that the loans were not, in fact, correspondent loans and therefore the commission amount should have been included.

At the time of the change in 2004, KPMG asked New Century to quantify the overstatement in deferred costs for the quarters prior to the third quarter 2004 in which the Company had included commissions paid to New Century employees in obtaining correspondent loans. KPMG relied on Kenneally's representation that the maximum overstatement in the deferred costs balance for correspondent loans was $1.5 million. Because the amount was less than the KPMG audit difference posting threshold, KPMG elected not to propose an adjustment. It does not appear from the workpapers that KPMG ever verified Kenneally's representation regarding the dollar amount. KPMG's acceptance of Management's explanation of the maximum overstatement in the deferred costs balance for correspondent loans made prior to third quarter 2004 reflects a failure to obtain reliable evidence[705] and failure to exercise appropriate professional skepticism.[706]

KPMG failed to identify that New Century was misclassifying correspondent loans and, therefore, not deferring specific costs for the period from third quarter 2004 through second quarter 2006. While it was determined in second quarter 2006 that the method utilized prior to third quarter 2004 was actually the correct method because the loans were not correspondent

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[704] AU § 230

[705] AU § 326

[706] AU § 230

loans, it is not clear what measures were taken by KPMG to investigate and/or quantify the accounting variance based on the exclusion of the amounts from the third quarter 2004 to the second quarter 2006. The failure to identify the mislabeling of the correspondent loans, and the apparent lack of documentation regarding KPMG's investigation thereof, reflects a failure to obtain reliable evidence[707] and failure to exercise appropriate professional skepticism.[708] Additionally, there is no indication that KPMG attempted to determine the effect of the misclassification on the deferred cost balance in the previous quarters. The Examiner is unable to determine whether the impact of the error was material and therefore required adjustment.

In the fourth quarter of 2006, KPMG determined that New Century misapplied the level-yield method and identified an adjustment of $261,060 as a result of a failure by New Century to factor interest income into its computations under FAS 91. According to KPMG, the error originated in the models designed by Secondary Marketing. KPMG's workpapers do not reflect any intention to address the impact of the failure to account for interest income on New Century's statement of earnings in prior quarters. KPMG failed to act with reasonable care and diligence in its failure to look-back to other quarters to determine the origin and financial impact of the mistake.[709]

d. Hedging

New Century used derivative instruments in an attempt to insulate itself against the possibility of interest-rate shifts detrimentally impacting the Company's cash flow from loans held for investment (and, to a lesser extent, against potential adverse changes in the value of its loans held for sale). Specifically, the Company used certain Euro Dollar futures contracts, interest rate swap contracts and interest rate cap contracts for this purpose.

In connection with the 2005 audit, as discussed above, KPMG appointed FDR specialist John Klinge to the New Century engagement.[710] In connection with his review of New

[707] AU § 326.

[708] AU § 326.

[709] AU §§ 312, 329

[710] No such specialist assisted with the 2004 audit, however. Moreover, KPMG's 2004 hedging workpapers do not appear to have been reviewed even by senior members of the engagement team: Neither the audit nor the concurring review partner signed off on any of the KPMG hedging memoranda, which left Athena Chan, (a manager) solely responsible for reviewing the hedging work of Beckstrom and Chinn (both of whom were first-year staff accountants). This relative lack of supervision and expertise in auditing a complex area of accounting during the 2004 audit marks a potential deviation from AU § 210 (training and proficiency of the independent auditor) and AU § 311 (planning and supervision).

Century's hedging for the 2005 audit, Klinge informed the engagement team that New Century had failed to account for at least some of its IRLC as derivatives, which represented a departure from GAAP. In New Century's 2005 financial statements, however, the Company stated that its "interest rate lock commitments are considered to be derivatives and are recorded on our balance sheet at fair value."[711] The KPMG engagement team determined that the impact of the GAAP departure on the financial statements was immaterial, but does not appear to have identified the disclosure discrepancy.

Citing FAS 133, paragraph 29(b) (which deals with forecasting the probability of a given transaction's occurrence), Klinge also raised questions during the 2005 audit regarding New Century's use of a 48-month assumption for interest cash flows, in light of the possibility for borrower prepayment. In particular, Klinge maintained that he had not seen adequate documentation to support this assumption. As discussed above, the matter was ultimately escalated to KPMG's DPP, which considered and effectively set aside Klinge's concerns on March 16, 2006, the deadline for filing the Company's Form 10-K (thereby allowing KPMG to issue its audit opinion and the Company to file the Form 10-K). Nonetheless, Klinge's documentation concerns do not appear to have been addressed at the time the Form 10-K was filed, and indeed, KPMG worked to document all matters to Klinge's satisfaction over the next 45 days and get appropriate sign-off memoranda from Klinge. Ultimately, KPMG required New Century to change its hedge accounting treatment going forward to conform to Klinge's concerns.

In addition, FAS 133 requires that a company's hedge documentation must be prepared *contemporaneously* with the inception of the hedging relationship. Internal KPMG communications reveal that KPMG was aware, as of June 2005, that much of the Company's hedge documentation for the first quarter of 2005 was in draft form. Although "contemporaneous" is not defined in FAS 133, the SEC generally has held public companies to a strict interpretation of the rule, and thus, draft documentation that is not finalized until some time after the inception of the hedging relationship likely does not satisfy FAS 133. KPMG should have required New Century to furnish final documentation under GAAP and its failure to do so reflects a lack of due care.

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[711] Form 10-K for 2005, p. 80.

e. Goodwill

Of the $80.6 million purchase price for its Home123 subsidiary's acquisition of RBC Mortgage's prime mortgage origination platform in September 2005, New Century recorded $77.7 million in goodwill. The RBC Mortgage business unit sustained losses of approximately $17 million between the date of acquisition in September 2005 and the end of 2005, which was worse than New Century had forecasted.[712] KPMG conducted goodwill impairment testing in connection with its 2005 audit, but concluded that no impairment was warranted despite the $17 million in losses.

Goodwill impairment testing involves two steps under FAS 142. First, the business unit's fair value is compared with its carrying amount. If the fair value exceeds its carrying amount, no additional testing is required and no impairment charge is required. If, however, the carrying amount of the business unit exceeds its fair value, a second more detailed analysis must be conducted to determine whether a goodwill impairment charge is necessary, and if so, the amount of that charge. Accordingly, KPMG's goodwill impairment testing consisted of comparing the RBC Mortgage business unit's fair value, based on the Company's discounted cash flow analysis, with its carrying value. Determining that the fair value exceeded the carrying value, KPMG concluded that no impairment was warranted. However, the revenue projections on which KPMG relied were not well documented, and the discount rate the Company's cash flow model used was questionable.

Although KPMG's 2005 audit workpapers contain New Century's discounted cash flow analysis for the RBC Mortgage business unit, the workpapers do not appear to contain any evidence that KPMG ever tested or questioned, with any degree of professional skepticism, the Company's underlying revenue assumptions that were used to generate the cash flows. In addition, KPMG did not document its understanding of the source of the revenue projections or RBC's ability to achieve the forecasted revenues. KPMG merely analyzed certain calculations of the Company's goodwill valuation and inquired of Management about the nature of certain assumptions. When interviewed by the Examiner, Kim acknowledged that testing the revenue projections would be a necessary step in the goodwill valuation but could not identify any workpapers documenting that KPMG conducted any such testing. Because the determination of RBC's fair value begins with the present value of cash flows (which is primarily driven by

[712] Form 10-K for 2005, at pp. 57-58.

revenue projections), without support for the revenue projections, the fair value cannot meaningfully be compared to the carrying value.

Moreover, even when RBC incurred losses of $17 million in the first four months following the acquisition, neither Kim nor Donovan were concerned with the possible impairment of goodwill nor were they skeptical of the $18 million in projected net income for 2006. In interviews with the Examiner, both maintained that the Company expected early losses following the acquisition and four months was too short of a period to be concerned with goodwill impairment. In fact, Donovan said he did not expect the audit engagement team to make any attempt to ascertain whether RBC had been experiencing losses, or anything else regarding its profitability, despite FAS 142's requirements that goodwill be tested for impairment on at least an annual basis.

KPMG's 2005 audit workpapers also do not appear to contain any evidence that KPMG questioned or tested New Century's discount rate assumption of 15%. The Company used 20% when internally analyzing the prime mortgage platform's future business plans. Had a 20% discount rate been used rather than 15%, New Century would have been required to at least conduct the second step of impairment testing, the more detailed analysis, in order to determine if goodwill should have been impaired.

Similarly, the Examiner concludes that KPMG failed adequately to audit New Century's goodwill impairment testing in connection with its 2005 audit. KPMG's 2005 workpapers do not appear to contain any documentation that evidences testing of the revenue and gross profit projections upon which New Century relied or even the source of those projections. The KPMG audit team apparently did not question or rigorously test those revenue or gross profit projections, but instead focused on the mathematical accuracy of the calculations used by the Company's cash flow model. It also does not appear that the audit team raised questions during the 2005 audit concerning the 15% discount rate that the Company used in that model. KPMG's apparent failure to obtain sufficient competent audit evidence to support the reasonableness of the critical assumptions underlying the Company's fair value measurement, which were at the core of KPMG's impairment testing at year-end 2005, was inconsistent with KPMG's obligations under GAAS.[713]

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[713] AU § 328

5. KPMG's 2005 SOX 404 Audit Was Not Conducted with Due Care.

The Examiner finds that KPMG's 2005 review of the adequacy of New Century's internal controls over financial reporting was not conducted in accordance with AS 2 in certain significant respects, as discussed below. On a preliminary note, the Examiner observes that, in general, the 2005 review appears to have been less rigorous than either the 2004 review or the subsequent 2006 review. The Examiner believes that this likely is attributable to the limited relevant experience of the senior associate primarily responsible for the review, Biddle, as discussed above.

a. KPMG Failed to Identify Control Deficiencies that Existed at the Time of Its 2005 Audit.

As discussed above, KPMG failed to identify certain deficiencies in its 2005 audit of New Century's internal controls with respect to repurchase reserves and residual interest valuations. Many of these deficiencies were noted in the draft workpapers for the 2006 audit of internal controls as both material weaknesses and significant deficiencies, but they existed at the time of the 2005 audit and should have been identified at that time.

b. The 2005 SOX 404 Audit Team Did Not Consider Prior Deficiencies Noted When Planning the Review or Evaluating Their Findings.

The Examiner found no evidence that the KPMG engagement team engaged in a formal process to compare year over year deficiency findings in connection with the 2005 SOX 404 audit. Conducting this analysis would have been prudent given the wholesale turnover in the KPMG engagement team. This failure is significant, as it impacted the planning for the SOX 404 audit in 2005, the evaluation of findings in 2005 and the planning for the year-end audits.

Specifically, the Examiner found no evidence of any significant communication between the 2004 and 2005 engagement teams regarding the SOX issues in workpapers, e-mails or interviews. Highlighting this point, Biddle told the Examiner that she never discussed the New Century audit engagement with the 2004 audit engagement partner, Kinsella, even though she knew Kinsella and was working with him on another engagement in 2005. Biddle also stated that she did not perform a formal review of the internal control deficiencies identified in the prior year or Management's remediation of those deficiencies.

Under AS 2, an auditor is required to consider the following when planning a SOX 404 audit:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.
- Control deficiencies previously communicated to the audit committee or management.
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.

By not considering the prior year's deficiencies, the planning for the 2005 SOX 404 audit did not comply with AS 2.

In addition, because they were not aware of certain recurring deficiencies, the KPMG SOX 404 audit team did not consider all of the information available to them when assessing the significance of the deficiencies noted in 2005. For example, as discussed above, KPMG concluded in connection with its 2004 SOX 404 audit that New Century lacked adequate documentation supporting its valuation of residual interests. Although KPMG reported this deficiency to Management, KPMG's workpapers do not adequately explain how the documentation deficiency was remediated by the Company, and the Examiner does not believe, based on his review of the support provided, that the Company did remediate the deficiencies.

In 2005, KPMG identified 13 control deficiencies relating to the residual interest process. However it raised *none* of them as significant deficiencies, which would have necessitated a report to New Century's Audit Committee. Notably, the identified deficiencies included several of the same concerns that were raised as significant deficiencies in 2004 and again later in 2006. Moreover, the KPMG team failed to document its methodology for determining the severity of various control deficiencies identified during the 2005 SOX 404 audit as required by AS 2. The absence of this documentation corroborates the Examiner's conclusion that many of KPMG's severity determinations were based on minimal analysis.

Had the 2005 engagement team considered the 2004 findings, KPMG should have concluded that, at a minimum, significant control deficiencies had persisted with respect to residual interests. These findings would have been reported to New Century's Audit Committee, as required by AS 2. As a result of these inadequacies in KPMG's review, however, the Audit Committee was never provided with the opportunity to address the recurring deficiencies.

In connection with the 2006 SOX 404 review, KPMG documented multiple internal control deficiencies with respect to the residual interest valuation in its draft audit workpapers and assessed internal controls as not operating effectively. These deficiencies, which are as

follows, also would have existed at the time of the 2005 audit but were not identified then by KPMG:

- Management does not have a regular, documented process in place to determine a threshold at which to adjust assumptions in the residual asset models.
- Management does not have adequate documentation to support the reasonableness of the 12-14% discount rates used in the valuation of the residual interests for the following reasons.
- No external bid for residuals has been obtained.
- Management analysis supports 13-18% discount rates for CMO securities.
- Management benchmarking indicates the discount rates used by the Company are lower than competitors' rates for comparable transactions.
- Company should independently validate the models to ensure mathematical accuracy of the models and accurate valuation based on market conditions.

A number of these deficiencies also were found by PwC in February 2007 when it was retained by Bindra at New Century to review certain models and the valuation process. PwC noted, in particular, a lack of documentation to support certain assumptions and a lack of controls for changes in assumptions used in the models. The fact that KPMG did not identify in 2005 these same control issues, but instead assessed internal controls as effective, is evidence of a lack of professional care in the performance of the 2005 SOX 404 review.

6. Representations to Audit Committee

GAAS requires independent auditors to communicate with their audit committee clients regarding, among other things, the Company's critical accounting policies and changes to those policies, their opinions regarding the soundness of those policies, and the foundation for and reasonableness of management's judgments regarding estimates.[714] In accordance with this rule, Donovan and Kim gave regular reports to the Audit Committee. These reports, however, were not accurate. In particular, KPMG, through Donovan and Kim, gave assurances to the Audit Committee throughout the relevant time period that the repurchase reserve estimate and residual interest valuations were reasonable, that there were no changes to the Company's critical accounting policies and that the accounting policies complied with GAAP.

[714] AU § 380.02.

The following is typical of the representations made by KPMG, as reported in the Company's minutes for an Audit Committee meeting on May 9, 2006, at which KPMG discussed its review of New Century's interim financial statements for the first quarter of 2006:

> In response to a question of the Committee, Mr. Donovan noted that none of the review matters required changes to the Corporation's critical accounting policies . . . .
>
> Mr. Kim reported that the Corporation had not adopted any new significant accounting policies and that its accounting policies were all in accordance with [GAAP]. . . .
>
> Mr. Kim reported that the basis for management's judgments and estimates relating to the valuation of mortgage servicing rights, the valuation of residual interests, the allowance for loan losses and the Corporation s repurchase reserve were reasonably stated and that KPMG had not discovered any material differences in these estimates.

Zona confirmed to the Examiner that these minutes described a "routine report from KPMG where they discussed their review of the main judgment areas. Typically, KPMG would report that they reviewed these areas, no changes in methodology were made and that KPMG believed that the accounts were reasonably stated." Donovan made substantially similar remarks regarding KPMG's reviews of the second and third quarter 2006 interim financial statements, as reflected in the minutes for the Audit Committee meetings on August 2, 2006 and November 7, 2006. KPMG's audit opinion for year-end 2005 also stated that New Century's financial statements were presented fairly and in conformity with GAAP. Further, its SOX 404 opinion concluded that there were no material weaknesses in the Company's internal controls over financial reporting.

As discussed above, the Examiner has found that KPMG's conclusions were not sound. In particular, the residual interest valuations were *not* reasonable, the repurchase reserve was *not* sufficient, and the financial statements were materially misstated as a result. In addition, certain changes were made to the methodology for calculating the repurchase reserve—a critical accounting policy—and the Audit Committee was not informed of these changes. Accordingly, KPMG's representations to the Audit Committee were not accurate, and the Audit Committee was not properly informed as was required under GAAS, of the serious flaws in New Century's financial reporting.

XII. POTENTIAL CAUSES OF ACTION

In the June 1 Order, the Court directed the Examiner to "identify and evaluate any claims or rights of action that the estates might have" related to New Century's accounting and financial statement "irregularities, errors or misstatements."[715] The June 1 Order also prohibited the public disclosure of any evaluation by the Examiner with respect to "the strengths or weakness of any potential claim or right of action the estates may have or suggested litigation strategy in connection therewith," absent further order from the Court.[716]

The following summarizes the Examiner's analysis of potential causes of action in a manner that recognizes the sensitivity ascribed to public disclosure of these matters by the Court.

A. Executive Summary

The Examiner has determined that a number of potential causes of action may be available to the estates. First, the estates may be able to assert causes of action against KPMG for professional negligence and negligent misrepresentation. The Examiner has determined that the estates may assert that KPMG breached its professional standard of care in its audit and quarterly reviews of the Company's financial statements and its related systems of internal controls. Among other things, the Examiner found that KPMG failed to exercise due care in planning and carrying out its audits and reviews, failed to demonstrate appropriate professional skepticism with respect to Management's judgments and representations, and failed to obtain sufficient competent evidence to support its opinions and representations to the Company's Officers, Directors and shareholders. These failings by KPMG led to material misstatements in the financial statements of New Century. The Examiner believes the estates may seek to recover a broad range of damages proximately caused by KPMG's negligence, including, but not limited to: (a) the fees paid to KPMG in connection with its 2005 audit and its quarterly reviews of the Company's financial statements during 2006; (b) the legal, accounting and other costs incurred by the estates in connection with investigations of matters related to KPMG's negligence, including, but not limited to, costs associated with the Examiner's investigation; (c) losses suffered or expenses incurred in connection with payments that New Century might never have made (*e.g.*, incentive bonus payments to Senior Management) or transactions in which New

[715] June 1, 2007 Order Denying in Part and Granting in Part Motion of the United States Trustee for an Order Directing the Appointment of a Chapter 11 Trustee, or in the Alternative, an Examiner ("June 1 Order") ¶ 3.

[716] *Id.* ¶ 6.

Century might never have engaged (*e.g.*, stock share repurchases) had New Century's financial statements not been materially misstated; and (d) damages New Century suffered when, in early 2007, it was suddenly forced to announce that it needed to restate its 2006 financial statements on account of errors that had occurred, at least in part, because of KPMG's negligence. In addition, because KPMG's negligence may have been a proximate cause of New Century falling deeper into insolvency, the Examiner believes the estates may be able to recover additional damages from KPMG under the "deepening insolvency" theory of damages.

Second, the estates may be able to assert causes of action to recover bonuses and other forms of compensation paid to certain officers by New Century that were tied, directly or indirectly, to the Company's net income. The Examiner has determined that the Company's reported net income was materially overstated for 2005 and 2006. When adjustments are made to correct for these material inaccuracies, it becomes clear that the bonuses paid to certain New Century officers were inflated or undeserved. For example, the bonuses paid to Cole, Gotschall, Morrice, Cloyd and Flanagan with respect to 2005 were approximately $2.9 million greater than they should have been. Performance and mid-year bonuses paid to Cole, Gotschall and Morrice with respect to 2006 (totaling approximately $2 million) were undeserved altogether when accurate financial statements are taken into account. The Examiner believes these bonus amounts, and all or portions of certain quarterly bonuses paid to other senior executives in 2005 and 2006, may be recovered by the estates under unjust enrichment and bankruptcy law theories.

Third, the Examiner has reviewed various issues related to the conduct of former Officers and current and former Directors of New Century with respect to whether actions or inaction on the part of individual Officers or Directors may give rise to potential causes of action on behalf of the estates. The issues surrounding these possible claims are fact-specific and the Examiner observes that the legal standards applicable to potential causes of action against New Century's Officers or Directors present significant obstacles to recovery of money damages from the subject individuals. In particular, the business judgment rule and statutory or other limitations on liability applicable to New Century Officers and Directors require a substantial showing of misconduct, self-dealing and/or gross negligence to support a claim for liability. Accordingly, the Examiner has not undertaken to include in this Final Report a detailed discussion of such potential claims and related factual or legal considerations. Nonetheless, because questions and allegations may be raised with respect to the conduct and level of care observed by certain of the

Company's Officers and Directors, the Examiner is outlining some potential areas of concern below.

The potential causes of action the Examiner has considered may give rise to possible defenses, some of which may operate to defeat or reduce significantly the liability of the defendants. For example, KPMG and New Century Officers may assert defenses based upon the *in pari delicto* doctrine, or otherwise contest liability because of alleged unclean hands on the part of the Company, reasonable reliance on representations made by others, and/or deceptions or failures to disclose by persons at New Century. Further, as noted, current or former Directors or Officers of New Century may seek to reduce or avoid liability based upon the protections of the business judgment rule or indemnification provisions contained in the Company's organizational documents or language contained in individual employment agreements. The strengths or weaknesses of such defenses in individual cases may vary considerably, and in deference to the prohibition in the June 1 Order, the Examiner is not providing any evaluation of those strengths and weaknesses in this Final Report.

B. Legal Considerations Related to Potential Causes Of Action

1. Choice of Law

Claims on behalf of the estates may be brought in this Court under 28 U.S.C. § 1334(b) (2007).[717] In the Third Circuit, a bankruptcy court must apply the choice of law rules of the state in which the bankruptcy court sits. *See, e.g., PHP Liquidating, LLC v. Robbins (In re PHP Healthcare Corp.)*, 128 F. App'x 839, 843 (3d Cir. 2005); *Burtch v. Dent (In re Circle Y of Yoakum)*, 354 B.R. 349, 359 (Bankr. D. Del. 2006); *In re Garden Ridge Corp.*, 338 B.R. 627, 632 (Bankr. D. Del. 2006). Accordingly, the Court is to apply Delaware choice of law rules to determine which state's law applies to such claims.

a. Potential Claims Against KPMG

Both Delaware and federal common law choice-of-law rules provide that a bankruptcy court must follow the "most significant relationship" test of the Restatement (Second) of Conflict of Laws with respect to tort claims. *T. Frederick Jackson, Inc. v. Pepper, Hamilton & Scheetz, LLP (In re Olson Industries)*, No. 98-140, 2000 U.S. Dist. LEXIS 4897, at *35 (D. Del. 2000) (*citing Pig Improvement Co. v. Middle States Holding Co.*, 943 F. Supp. 392, 396 (D. Del.

[717] "Notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334(b).

1996)). In applying this test, courts consider "(a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicile, residence, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered." Restatement (Second) of Conflict of Laws § 145(2) (1971).[718]

The Examiner believes that, under the "most significant relationship" test, California law is likely to apply to claims that may be brought by the estates against KPMG. Most courts that have applied this test in the context of accounting malpractice claims have determined that the state with the most significant relationship is the state where the audit or accounting services were performed. *See, e.g., Trierweiler v. Croxton & Trench Holding Corp.*, 90 F.3d 1523, 1536-37 (10th Cir. 1996) (applying Colorado law to a Colorado law firm and accounting firm that performed work, including an audit of a Nevada corporation, in Colorado); *Nordica USA, Inc. v. Deloitte & Touche*, 839 F. Supp. 1082, 1085-86 (D. Vt. 1993) (applying Utah law under the Restatement test where alleged misconduct involved Deloitte audits in Utah). KPMG performed most work related to its audits and quarterly reviews of New Century in California at the Company's headquarters, which strongly suggests that California law governs potential claims against KPMG.[719]

b. Potential Claims Involving Corporate Internal Affairs

New Century Financial Corporation was incorporated as a real estate investment trust ("REIT") in Maryland in 2004. Delaware's choice-of-law rules require application of the law of the state of incorporation for all claims involving corporate internal affairs. *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115 (Del. 2005). This "corporate internal affairs" doctrine applies to the regulation of the relationships among a corporation and

[718] The court must also consider the following factors: "(a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue, (d) the protection of justified expectation, (e) the basic policies underlying the particular field of law, (f) certainty, predictability and uniformity of result, and (g) ease in the determination and application of the law to be applied." Restatement (Second) of Conflict of Laws § 6(2) (1971).

[719] The KPMG engagement letters contain arbitration provisions that designate New York, New York as the applicable forum. However, even if New York choice of law rules were applied, the Examiner believes that it is more likely than not that any claims brought by the estates against KPMG would be evaluated based on California law.

its officers, directors and shareholders.[720] Although principally related to shareholders' rights, the doctrine also governs the rights and liabilities of officers and directors. In particular, the doctrine applies to claims for breach of fiduciary duty, *see Coleman v. Taub*, 638 F.2d 628, 629 n.1 (3d Cir. 1981), and corporate waste. *See Official Comm. of Unsecured Creditors of Teu Holdings, Inc. v. Kemeny (In re Teu Holdings, Inc.)*, 287 B.R. 26, 32 (Bankr. D. Del. 2002). Therefore, the Examiner believes Maryland law would apply to claims against former officers of New Century for breach of fiduciary duty, including claims for corporate waste, brought on behalf of the estates.[721]

2. Statutes of Limitations

a. California

California has a two-year statute of limitations for claims of professional negligence or negligent misrepresentation against accountants.[722] Any such claim accrues when the plaintiff discovers (or through reasonable diligence should have discovered) the negligent act and suffers actual injury. *See Int'l Engine Parts, Inc. v. Feddersen & Co.*, 888 P.2d 1279, 1283-84 (Cal. 1995); *see also Moonie v. Lynch*, 256 Cal. App. 2d 361, 365-66 (Ct. App. 1967) (holding that, in a malpractice action against an accountant, "the statute of limitations does not run until the negligent act is discovered or with reasonable diligence could have been discovered"). Accordingly, claims arising from KPMG's alleged negligence in connection with its 2005 quarterly reviews, its 2005 audit, or its 2006 quarterly reviews had not expired when New

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[720] See Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 Law & Contemp. Probs. 161, 161 (1985).

[721] The Examiner has not concluded whether California or Maryland law would apply to the unjust enrichment claims described below. Under both Delaware and federal common law choice-of-law rules, the bankruptcy court must follow the "most significant relationship" test discussed above. *In re Olson Industries*, 2000 U.S. Dist. LEXIS 4897, at *35. Several facts might be relevant to the Court in its determination of the applicable law for claims other than those impacted by the internal affairs doctrine. The Company conducted a large portion of its business in California. Most of New Century's Officers and Directors resided in California, executed their employment agreements under the laws of California, and conducted most of their employment obligations in California. However, as noted, New Century Financial Corporation was incorporated as a REIT in Maryland. Considering those facts, it is difficult to predict with certainty how a court would rule with respect to the choice of law applicable to potential unjust enrichment claims against former New Century Officers, but, as described later in this Section of the Final Report, that choice may not be important because the legal standards for unjust enrichment claims in California and Maryland are similar. To the extent causes of action are brought under Company Officers' employment agreements, an agreement-by-agreement analysis would be necessary. A review of a sample of employment agreements indicates that California law usually applies.

[722] To the extent California law may be deemed to apply to claims against corporate officers, a three-year statute of limitations applies. Cal. Civ. Proc. Code § 338(d) (Deering 2007). California law could be implicated, for example, with respect to potential claims arising under the employment agreements for New Century executives.

Century filed its Chapter 11 voluntary petitions on April 2, 2007. *Int'l Engine*, 888 P.2d at 1280; *Apple Valley Unified Sch. Dist. v. Vavrinek, Trine, Day & Co. LLP*, 120 Cal. Rptr. 629, 635 (Ct. App. 2002); Cal. Civ. Proc. Code § 339(1) (Deering 2007).

b. Maryland

Under Maryland law, a three-year statute of limitations applies to civil actions. Md. Code Ann., Cts. & Jud. Proc. § 5-101 (LexisNexis 2008). Although § 5-101 provides that the statute of limitations begins to run when a cause of action "accrues," the term "accrue" is undefined in the statute. Therefore, the question of accrual has been left to judicial determination. To that end, courts have created exceptions to protect plaintiffs, the most important of which is the discovery rule. The discovery rule delays accrual of a claim where the cause of action is "inherently unknowable" and the plaintiff could not have reasonably known of the wrong within the limitations period. The Maryland Court of Appeals has declared that the rule applies generally in all civil actions. *Poffenberger v. Risser*, 431 A.2d 677, 680 (Md. 1981).

c. The Effect of 11 U.S.C. § 108(a)

If the statute of limitations has not run on a claim as of the bankruptcy petition date, 11 U.S.C. § 108(a) extends the time period for filing the claim by "two years after the order for relief." *Fruehauf Trailer Corp. v. Terex Corp. (In re Fruehauf Trailer Corp.)*, 250 B.R. 168, 185 (D. Del. 2000). For purposes of 11 U.S.C. § 108(a), filing a voluntary petition for bankruptcy protection operates as an order for relief. *Id.* Consequently, claims for which the statute of limitations had not run by April 2, 2007, the date New Century filed its petitions, will not be timed-barred until April 2, 2009.

C. The Estates Have Potential Causes of Action Against KPMG for Professional Negligence and Negligent Misrepresentation

The Examiner has evaluated his factual findings in the context of the relevant professional and legal standards applicable to KPMG. Based upon this review, the Examiner has determined that the estates possess potential causes of action against KPMG for professional negligence and negligent misrepresentation.

1. The Estates May State a Claim for Professional Negligence

Under California law, accountants constitute "a skilled professional class . . . subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions." *Lindner v. Barlow, Davis & Wood*, 27 Cal. Rptr. 101, 104 (Ct. App. 1962) (citation omitted). As such, accountants "have a duty to exercise the

ordinary skill and competence of members of their profession, and a failure to discharge that duty will subject them to liability for negligence." *Id.* (citation omitted).

A plaintiff must demonstrate the following elements to prevail on a claim for professional negligence against an accountant: "(1) the duty of the professional to use such skill, prudence, and diligence as other members of his profession commonly possess and exercise; (2) a breach of that duty; (3) a proximate causal connection between the negligent conduct and the resulting injury; and (4) actual loss or damage resulting from the professional's negligence." *Mattco Forge v. Arthur Young & Co.*, 60 Cal. Rptr. 2d 780, 788 (Ct. App. 1997) (citation omitted). The Examiner believes the facts uncovered during his investigation are sufficient to support each of these elements with respect to potential claims by the estates against KPMG.

a. KPMG Owed New Century a Duty of Professional Care

As its independent auditor, KPMG owed New Century a professional duty to perform its audits and quarterly reviews with the degree of skill, prudence, and diligence commonly exercised by members of the audit profession. Specifically, KPMG was required to "use the skill and due professional care and to exercise good faith and to observe generally accepted auditing standards [GAAS] and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances." *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990); *see also Flowers v. Torrance Mem'l Hosp. Ctr.*, 884 P.2d 142, 145 (Cal. 1994) (holding that "[w]ith respect to professionals, their specialized education and training . . . are considered additional circumstances relevant to an overall assessment of what constitutes 'ordinary prudence' in a situation. Thus, the standard for professionals is articulated in terms of exercising 'the knowledge, skill and care ordinarily possessed and employed by members of the profession in good standing'") (citations omitted). KPMG recognized this standard of care. For example, in its engagement letters, KPMG agreed to conduct the audits of the Company's financial statements and its internal controls over financial reporting in accordance with the rules and standards established by the PCAOB, which include GAAS.

b. KPMG Breached Its Duty of Professional Care

To determine whether KPMG breached its professional standard of care, a trier of fact should look to GAAS. *See Bily v. Arthur Young & Co.*, 834 P.2d 745, 749-52 (Cal. 1992) (observing that "[t]he planning and execution of an audit . . . require[s] a high degree of

professional skill and judgment" and describing the application of GAAS and GAAP to a financial statement audit). *See also Sharp Int'l Corp. v. KPMG LLP (In re Sharp Int'l Corp.)*, 278 B.R. 28, 33-34 (Bankr. E.D.N.Y. 2002) (holding that trustee sufficiently alleged that KPMG had "failed to gather sufficient competent evidential matter to support the financial statements," and "failed to exercise requisite skepticism in its audits"). Although a deviation from GAAS does not constitute negligence *per se*, courts have held that such violations impose a trial burden of explanation on the auditor. *Mishkin*, 744 F. Supp. at 537-38 (noting that plaintiff retains the burden of proof on the whole case to establish the auditor's negligence); *see also Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994) (stating that "compliance with GAAP and GAAS do not immunize an accountant who consciously chooses not to disclose in a registration statement a known material fact").

The Examiner believes that sufficient evidence exists to permit the estates to allege that KPMG breached its duty of professional care in performing its 2005 audit and quarterly reviews of the interim financial statements of New Century during 2006.[723] The estates may contend that KPMG's multiple departures from GAAS, as described elsewhere in this Final Report, resulted in its failure to detect that New Century's financial statements were not fairly presented in conformity with GAAP.

More specifically, the Examiner found evidence that may permit the estates to assert that KPMG violated fundamental tenets of GAAS by, among other things:

- not planning and preparing its audits and reviews appropriately in light of the risks of the engagement, including known defects in the control environment and certain aggressive assumptions used as part of New Century's accounting practices;
- not providing advice to New Century that was consistent with GAAP regarding the Company's methodology for calculating the loan repurchase reserve and its methodology for calculating lower of cost of market ("LOCOM") adjustments for repurchased loans;
- not exhibiting the appropriate amount of professional skepticism in reviewing the methodology employed by New Century to calculate its repurchase reserve and by ignoring critical evidence that indicated the methodology was flawed, which resulted in a material understatement of the reserve and overstatement of the Loans Held For Sale ("LHFS") portfolio;

[723] *See Murphy v. BDO Seidman, LLP*, 6 Cal. Rptr. 3d 770, 783 (Ct. App. 2003) (holding that "even if reviews are less rigorous than audits, the relaxed standards were not a license to misrepresent"); *Anderson v. Deloitte & Touche LLP*, 66 Cal. Rptr. 512, 516-17 (Ct. App. 1997).

- not criticizing New Century's reliance, through 2006, upon outdated and inadequate internally-developed models to value residual interests worth hundreds of millions of dollars, even though KPMG's reviews and audits detected multiple flaws in those models;
- not pressing New Century to correct its use of low discount rates in its residual interest valuation models (which tended to result in inflated valuations of the Company's residual interests), notwithstanding concerns expressed repeatedly by KPMG specialists;
- not addressing effectively New Century's continued use of other key assumptions that had been questioned by KPMG specialists regarding the residual interest valuation models;
- not considering seriously concerns expressed by KPMG specialists about errors identified during prior periods with respect to the Company's allowance for loan losses and its accounting for, mortgage servicing rights, amortization of loan fees and costs, and hedging;
- not obtaining sufficient competent evidentiary matter through inspection, observation, inquiries, and confirmation to afford a reasonable basis for opinions regarding the audited financial statements;
- not obtaining an understanding of the Company's internal controls sufficient to plan the audit and determine the proper nature, timing, and extent of substantive testing;
- as part of its SOX 404 audit, not uncovering material weaknesses and significant internal control deficiencies relating to the repurchase reserve process and not recognizing certain recurring deficiencies that reflected the overall weak control environment at New Century; and
- not acting to address weaknesses and deficiencies revealed by the SOX 404 audit with respect to residual interests and by failing to insist upon adequate remediation of those deficiencies.

c. The Breach by KPMG Proximately Caused Injury to the Estates

The Examiner has found that material misstatements regarding New Century's repurchase reserve, LOCOM valuation account and residual interests rendered New Century's financial statements unreliable. The Examiner also has determined that other elements of New Century's accounting policies and related procedures were inadequate. In light of these findings and the above-described failings by KPMG, the Examiner believes the estates may allege that KPMG proximately caused them injury because KPMG did not (1) detect or recommend that New Century correct the Company's material misstatements, (2) propose audit differences related to the repurchase reserve, LOCOM valuation account or residual interest valuations, or

(3) issue an adverse audit opinion. The estates also may allege that, as a result of KPMG's professional negligence, New Century proceeded without correcting its financial statements or even recognizing the possibility of restatement that was presented by its improper accounting methods. By the time New Century discovered the extent of the accounting irregularities and material misstatements, the subprime market was in a precipitous decline. The material misstatements resulted in New Century not being able to file its 2006 Annual Report on Form 10-K. Shortly after New Century announced on March 2, 2007 that it would not be filing its Annual Report on time, there were increased margin calls by the Company's warehouse lenders and further financings for the Company were denied. New Century could not survive without the financings, and the Company filed for bankruptcy protection on April 2, 2007.

d. Damages

The measure of damages the estates would be entitled to seek against KPMG for professional negligence is governed by statute and is equal to the amount that "will compensate for all the detriment proximately caused" by KPMG's breach of duty, whether or not that detriment was foreseeable.[724] As the statute suggests and case law holds, the range of potential damages the estates might seek is quite broad.

First, a number of courts have awarded clients the accounting and auditing fees they paid to accountants who committed professional malpractice.[725] Thus, the estates potentially may

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[724] The California Code states: "For the breach of an obligation not arising from contract, the measure of damages, except where otherwise expressly provided by this Code, is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not." Cal. Civ. Code § 3333 (Deering 2007).

[725] *See, e.g., Stanley L. Bloch, Inc. v. Klein*, 258 N.Y.S.2d 501, 508 (N.Y. Sup. Ct. 1965) (holding the plaintiff was entitled to recover from defendants: (1) "the accounting and auditing fees paid to defendants for the one year of services rendered by them immediately prior to the issuance of the erroneous balance sheet;" and (2) "the accounting and auditing fees necessitated by the review of this erroneous statement"); *see also Gordon v. Basroon (In re Plaza Mortgage & Fin. Corp.)*, 187 B.R. 37, 44 (Bankr. N.D. Ga. 1995) (holding that in action against debtor's former accountants for malpractice and fraud arising out of the operation of debtor as a "Ponzi" or pyramid scheme, damages could include accounting fees paid and "other accepted methods of measuring damages suffered by debtors"); *World Radio Labs., Inc. v. Coopers & Lybrand*, 557 N.W.2d 1, 15 (Neb. 1996) (holding that plaintiff was entitled to recover both fees it paid to its accounting firm and fees paid to another firm as a result of the original accountant's negligence because "an accountant is not entitled to fees for preparing false financial statements") (citing 1 Am. Jur. 2d *Accountants* § 13, at 537 (1994); *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969); and *Bd. of County Comm'rs v. Baker*, 102 P.2d 1006 (Kan. 1940)). Although the Examiner is not aware of a California case directly on point, he believes that California would permit the recovery of both accounting and auditing fees paid to KPMG, as well as accounting and auditing fees necessitated by KPMG's errors. *See, e.g., FDIC v. O'Melveny & Myers*, 969 F.2d 744, 752 (9th Cir. 1992), *rev'd on other grounds, O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994), *reaff'd on remand, FDIC v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995) (holding that if the client was successful in proving professional negligence, negligent misrepresentation or breach of fiduciary duty against its former attorney, the "out of pocket costs to the client properly attributable to the fraudulent transaction," including any fees paid to the law firm, would be the appropriate measure of damages); *see also Sahadi v. Scheaffer*, 66 Cal.

recover the fees paid by New Century to KPMG with respect to KPMG's audit work and quarterly reviews concerning 2005 and 2006. The Examiner has determined that the aggregate amount of such fees exceeds $5 million.

Second, courts have held that the kind of "detriment" for which a victim of professional malpractice may recover includes, among other things, investigation costs. *Apple Valley*, 120 Cal. Rptr. at 640; *see also Jordache Enterprises, Inc. v. Brobeck, Phleger & Harrison*, 958 P.2d 1062, 1070 (Cal. 1998). Accordingly, the estates potentially may recover from KPMG the legal, accounting and other costs the Company has incurred with respect to reviews and investigations related to the Company's interactions with KPMG, including costs associated with the investigations that have been and are being conducted by the Examiner, the SIC, the SEC, and the U.S. Department of Justice. To the extent that New Century has incurred costs or may incur costs in connection with shareholder litigation that challenges the accuracy of the Company's financial statements and related disclosures, those costs may also be recoverable.

Third, the estates potentially may be able to recover other losses that New Century suffered or expenses that New Century incurred in connection with payments that New Century might never have made (*e.g.*, incentive bonus payments to Senior Management) or transactions in which New Century might never have engaged (*e.g.*, stock share repurchases) had New Century's financial statements not been materially misstated as a consequence of KPMG's negligence. For example, as discussed below, New Century paid millions of dollars in undeserved incentive bonuses to New Century Officers based upon the mistaken belief that New Century had earned certain amounts of net income which, in fact, New Century had not earned. Had New Century's financial statements not been materially misstated in 2005 and 2006 as a result of KPMG's negligence, payments like those would not have been made. Similarly, New Century spent tens of millions of dollars on stock repurchases that the Company might not have made had it realized that its financial statements were weaker than they appeared.

Fourth, New Century suffered a wide range of damages when, in early 2007, it was suddenly forced to announce that it needed to restate its 2006 financial statements on account of errors that had occurred, at least in part, because of KPMG's negligence. As a direct

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Rptr. 3d 517 (Ct. App. 2007) (holding that an accountant's alleged failure to adequately or properly prepare the clients' tax returns resulted in significant "consequential losses," including audit fees paid to another accountant and attorney's fees).

consequence of that announcement, New Century's stock price and market capitalization dropped precipitously, the Company's lenders initiated margin calls, the Company's liquidity disappeared, it no longer could accept new loan applications, the Company was delisted by the New York Stock Exchange, and, ultimately, the Company filed for bankruptcy protection. KPMG's professional malpractice was a trigger for this disastrous series of events. The estates potentially may recover some or all of those damages from KPMG, to the extent that the estates can prove they were proximately caused by KPMG's professional malpractice.

Finally, the estates potentially may recover additional damages from KPMG under the "deepening insolvency" theory of damages. *See Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1004 (9th Cir. 2005) (holding trustee's complaint alleged a cognizable harm to the bankrupt corporation by alleging defendants, including the audit firm, "'prolonged' the firm's existence, causing it to expend corporate assets that would not have been spent 'if the corporation [had been] dissolved in a timely manner") (citation omitted).[726] This theory of damages is appropriate where there has been negligent conduct by auditors and the negligence was a proximate cause of the audited entity falling further into insolvency. In calculating damages stemming from accounting malpractice that may apply in a deepening insolvency context, at least one court has allowed a model that determined the amount as the difference between the enterprise value at the time the audit report was issued and the enterprise value at the time of bankruptcy to factor in the delay in filing.[727] California law permits a plaintiff to seek such damages. *See Arthur Andersen LLP v. Superior Court*, 79 Cal. Rptr. 2d 879, 890-91 (Ct. App. 1998) (rejecting Andersen's contention that it could have no liability for causing "deepen[ing] insolvency").

2. The Estates May State a Claim for Negligent Misrepresentation

Accountants may also be held liable for negligent misrepresentation. "Negligent misrepresentation is the assertion of a false statement, honestly made in the belief it is true, but

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[726] *See also Allard v. Arthur Andersen & Co.*, 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (recognizing the "deepening insolvency" theory of damages and rejecting Arthur Andersen's claim that the trustee could not recover damages based on further indebtedness to trade creditors); *Alberts v. Tuft (In re Greater Cmty. Hosp. Corp. I)*, 353 B.R. 324, 337-38 (Bankr. D.D.C. 2006). *But see Seitz v. Detweiler, Hershey & Assoc. (In re Citx. Corp., Inc).*, 448 F.3d 672, 678 (3d Cir. 2006) (questioning application of the deepening insolvency theory of damages); *Trenwick Am. Litig. Trust v. Ernst & Young LLP*, 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd, Trenwick Am. Litig. Trust v. Billet*, No. 495, 2007 Del. LEXIS 357 (2007) (same).

[727] *Greenstein, Logan & Co. v. Burgess Mktg., Inc.*, 744 S.W.2d 170, 186 (Tex. App. 1987) (finding that a jury could have reasonably concluded from the evidence that the negligent failure of the accounting firm to perform audits in accordance GAAS was a "substantial factor" in bringing about the company's bankruptcy, and that the damage "would not have occurred but for such negligence").

without reasonable ground for such belief." *Anderson v. Deloitte & Touche LLP*, 66 Cal. Rptr. 2d 512, 516 (Ct. App. 1997). Under California law, "[i]f the acts or conduct of a professional accountant . . . fall below the applicable standard of care for the profession, in that the accountant failed to examine or acquire the necessary information required to support the accountant's professional opinion . . . the opinion is made without a reasonable ground for believing it to be true." *Id.* at 517 (recognizing that an accountant's professional opinion may be regarded as a "positive assertion of fact"). Such claims have been alleged successfully in the context of accounting malpractice cases.[728]

In light of the evidence collected in his investigation, the Examiner has determined that the estates may be able to assert a claim against KPMG for negligent misrepresentation based on at least the following statements:

- the statement in KPMG's unqualified 2005 audit report that New Century's consolidated financial statements "present fairly, in all material respects" the financial position of New Century;
- KPMG's representations that the audits were performed in accordance with GAAS;
- KPMG's representations relating to the lack of internal control weaknesses when, in fact, they were present;
- KPMG's erroneous advice related to the GAAP requirements for calculating the repurchase reserve and the LOCOM valuation allowance; and
- KPMG's repeated assurances to the Audit Committee regarding critical accounting areas that reflect deficiencies, including the Company's calculation of the repurchase reserve.[729]

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[728] *See, e.g., R.D. Kushnir & Co. v. Adler Drobny Fischer LLC (In re Sec. Investor Prot. Corp.)*, 274 B.R. 768, 779 (Bankr. N.D. Ill. 2002) (holding that the trustee for the debtor corporation had successfully pleaded negligent misrepresentation against its auditors based on misrepresentations by the auditors in their opinion letters that: (1) the audits were performed in accordance with GAAS; (2) the financial statements were fairly presented in accordance with GAAP; (3) no material weaknesses in internal controls had been observed; and (4) the client's net capital was in compliance with regulatory requirements); *see also Metro. Mortg. & Sec. Co., Inc. v. PriceWaterhouseCoopers, LLP*, No. CV-05-290, 2005 U.S. Dist. LEXIS 39851 (E.D. Wash. Dec. 21, 2005) (denying former independent auditor's motion to dismiss complaint for professional negligence, negligent misrepresentation, and breach of contract premised on the fact that the bankrupt company's financial statements audited by PWC violated GAAP, standards of professionalism, and standards of field work); *Cumis Ins. Soc'y Inc. v. Tooke*, 739 N.Y.S.2d 489, 493 (App. Div. 2002) (citations omitted) ("Accounting malpractice or professional negligence contemplates a failure to exercise due care and proof of a material deviation from the recognized and accepted professional standards for accountants and auditors, generally measured by GAAP and GAAS . . . which proximately causes damage to plaintiff").

[729] *Anderson*, 66 Cal. Rptr. 2d at 516 (holding that "[w]hen a statement, although in the form of an opinion, is 'is not a casual expression of a belief' but 'a deliberate affirmation of the matters stated,' it may be regarded as a positive assertion of fact and [others] . . . may reasonably rely . . . on [that] knowledge, information, or expertise").

With respect to a potential claim for negligent misrepresentation, the estates may recover the same categories or types of damages as they would seek to recover in asserting a claim for professional negligence, as discussed above.

3. Possible Defenses That May Be Asserted by KPMG

The categories of defenses KPMG might assert with respect to claims brought on behalf of the estates include:

a. Comparative Negligence

KPMG might assert the defense that New Century's Accounting personnel were negligent in the performance of their duties and that such negligence limits KPMG's liability for professional negligence. The relevant California Code section states: "Everyone is responsible, not only for the result of his or her willful acts, but also for an injury occasioned to another by his or her want of ordinary care or skill in the management of his or her property or person, except so far as the latter has, willfully or by want of ordinary care, brought the injury upon himself or herself." Cal. Civ. Code § 1417 (Deering 2007).

California adheres to a "system of 'pure' comparative negligence, the fundamental purpose of which [is] to assign responsibility and liability for damage in direct proportion to the amount of negligence of each of the parties." *Li. v. Yellow Cab Co.*, 532 P.2d 1226, 1243 (Cal. 1975). Accordingly, to the extent that KPMG can show negligence on the part of the Debtors, damages may be apportioned between the parties. The California Supreme Court has granted broad discretion to trial courts to ensure that the comparative negligence rule is applied "in the interest of justice." *Id.; see also Daly v. General Motors Corp.*, 575 P.2d 1162, 1173 (Cal. 1978) (*quoting Hoffman v. Jones*, 280 So.2d 431, 439-40 (Fla. 1973)) ("we scrupulously abstained from issuing a detailed guidebook to the new area of comparative negligence, preferring to adopt the view of a Florida court that '. . . the trial judges of this State are capable of applying [a] comparative negligence rule without our setting guidelines in anticipation of expected problems'").

b. Unclean Hands

The equitable defense of unclean hands may bar recovery if misconduct on the part of a defendant: (1) is imputable to the corporation; (2) can be imputed to any bankruptcy trustee; and (3) is sufficiently related to the causes of action asserted in the case. *Peregrine Funding, Inc. v. Sheppard Mullin Richter & Hampton LLP*, 35 Cal. Rptr. 3d 31, 46 (Ct. App. 2005). The doctrine

is qualified by the requirement that the party against whom it is invoked has directly "infected" the actual cause of action before the court, and is not merely guilty of some unrelated improper past conduct. *Pond v. Ins. Co. of N. Am.*, 198 Cal. Rptr. 517, 521-22 (Ct. App.1984).

c. In Pari Delicto[730]

Under the doctrine of *in pari delicto*, "when a participant in illegal, fraudulent, or inequitable conduct seeks to recover from another participant in that conduct, the parties are deemed *in pari delicto*, and the law will aid neither, but rather, will leave them where it finds them." *Casey v. U.S. Bank Nat. Assoc.*, 26 Cal. Rptr. 3d 401, 404 n.1 (Ct. App. 2005) (citation omitted). Generally, if the wrongdoing of officers or directors is imputed to the corporation, the doctrine of *in pari delicto* bars suit by the bankruptcy trustee. *Id.* at 404-05.

Courts have applied a multi-part test to assess the *in pari delicto* defense. First, agents of the corporation must have participated in the wrongdoing for which the corporation seeks to recover. *In re Crown Vantage, Inc.*, No. 02-3836, 2003 WL 25257821, at *7 (N.D. Cal. Sept. 25, 2003), *aff'd, Crown Paper Liquidating Trust v. PriceWaterhouseCoopers LLP*, 198 F. App'x 597 (9th Cir. 2006). Second, the agents must have acted in the interest of the corporation. Third, if they did not, then the "adverse interest exception" applies, under which agents' actions are not imputed to the corporation. *Id.*

D. The Estates May Assert Claims to Recover Executive Bonuses Or Other Compensation Paid to Certain Officers Based On Material Misstatements Regarding the Company's Financial Performance

The Examiner believes the estates may be able to recover incentive compensation paid by New Century to some Officers, including large bonuses paid to the Company's founders, which were tied, directly or indirectly, to the Company's net income in 2005 and 2006. Such bonuses sprang from material misstatements in the Company's financial statements and were improperly large or underserved altogether. The Examiner believes the estates may assert claims to cause these former officers to return these bonuses on grounds that they were unjustly enriched by such

[730] The rule of *in pari delicto* has been used by defendants to bar not only claims by a bankruptcy trustee, on the theory that the actions of an agent acting within the scope of his employment are imputed to the principal, but also to bar standing by a bankruptcy trustee. The *Wagoner Rule* is an influential expression of the doctrine that, depending on choice of law determinations, may be applicable. The *Wagoner Rule* has been applied to bar bankruptcy trustees, as successors to corporations, from bringing an action against the wrongdoing third party. *See Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991).

payments and that the estates are entitled to recover them under Section 548 of the Bankruptcy Code.

1. Certain Officers Were Unjustly Enriched

a. Claims for Unjust Enrichment Under California and Maryland Law

Both California and Maryland recognize the doctrine of unjust enrichment. Under California law, a plaintiff must prove receipt of a benefit and unjust retention of the benefit at the expense of another. *Lectrodryer v. Seoulbank*, 91 Cal. Rptr. 2d 881, 883 (Ct. App. 2000). *See also* Restatement (Second) of Restitution § 1 (1937). The recipient of the enrichment may raise equitable defenses, including reliance. *City of Hope Nat'l Med. Ctr. v. Super. Ct.*, 10 Cal. Rptr. 2d 465, 467 (Ct. App. 1992). *See also* Restatement (Second) of Restitution § 69 (change of circumstances).

Under Maryland law, a plaintiff may recover moneys paid to a defendant if three elements are shown: (1) the plaintiff confers a benefit upon the defendant; (2) the defendant knows of or appreciates the benefit; and (3) the defendant's acceptance or retention of the benefit under the circumstances is such that it would be inequitable to allow the defendant to retain the benefit without the paying of value in return. *Mona v. Mona Elec. Group, Inc.*, 934 A.2d 450, 473 (Md. Ct. Spec. App. 2007); *Comm'rs of Caroline County v. Dashiell & Sons, Inc.*, 747 A.2d 600, 607 n.7 (Md. 2000). *See also* Restatement (Second) of Restitution § 1 cmt. c. Recovery under unjust enrichment principles may be permitted even if the defendant has no knowledge that the funds rightfully belong to the plaintiff. *Plitt v. Greenberg*, 219 A.2d 237, 242 (Md. 1966).

b. Unjust Enrichment Has Been Used to Require Repayment of Executive Bonuses

Relying upon unjust enrichment principles, the Alabama Supreme Court recently affirmed a lower court's order that the former CEO of HealthSouth Corporation, Richard M. Scrushy, repay $47.8 million in bonuses he did not deserve once it became clear that HealthSouth had not reached the profit thresholds upon which those bonuses were contingent. *Scrushy v. Tucker*, 955 So. 2d 988 (Ala. 2006) (relying on Delaware and Alabama law). Scrushy's bonuses had been based on HealthSouth earnings, which the company later discovered were massively overstated due to accounting errors. The Alabama Supreme Court ordered repayment even under the assumption that Scrushy had no actual knowledge of, and no active

participation in, any of the activities that resulted in the falsification and fabrication of HealthSouth's financials. *Id.* at 999. Following Delaware law, the Alabama courts held that Scrushy had been unjustly enriched and that it would be "unconscionable" to allow him to retain the bonuses he did not deserve, regardless of whether he had participated in any wrongdoing. *Id.* at 1011 (*citing Fleer Corp. v. Topps Chewing Gum, Inc.*, 539 A.2d 1060, 1062 (Del. 1988)).

Although the court in *Scrushy* did not make explicit reference to it, the logic of its opinion is consistent with the contractual principle of mutual mistake. California and Maryland courts provide for the restitution of money paid under contract due to a mutual mistake of fact. *See Admiral Ins. Co. v. Am. Nat'l Savs. Bank*, 918 F. Supp 150, 153 (D. Md. 1996) (*citing Young v. Cities Serv. Oil Co.*, 364 A.2d 603 (1976)); *see also Debelius Realty Co. v. Chassagne*, 271 A.2d 527, 530 (Md. 1970); *Bridges v. Cal-Pac. Leasing Co.*, 93 Cal. Rptr. 796, 798 (Ct. App. 1971); *Finnegan v. Spiegl Farms, Inc.*, 44 Cal. Rptr. 645, 648 (Ct. App. 1965). There also is relevant authority for the position that a mistake of fact may be actionable if the mistake is material whether it is mutual or unilateral. *Bridges*, 93 Cal. Rptr. at 798. California and Maryland follow the Restatement (Second) of Restitution, which states: "A person who has paid another an excessive amount of money because of an erroneous belief induced by a mistake of fact that the sum paid was necessary for the discharge of a duty, for the performance of a condition, or for the acceptance of an offer, is entitled to restitution of the excess." Restatement (Second) of Restitution § 20 (1937). *See, e.g.*, *Bridges*, 93 Cal. Rptr. at 798; *Debelius*, 271 A.2d at 530. It is irrelevant whether the plaintiff was negligent. *Bridges*, 93 Cal. Rptr. at 800 (holding that repayment is required even if the payor could have discovered the mistake, unless the payee changed his position to such an extent that repayment would be unjust).

In *Scrushy*, the Alabama Supreme Court observed that the bonus provisions applicable to Scrushy's employment agreement and in the company's proxy statement required HealthSouth to meet annual performance standards before bonuses would be paid. *Scrushy*, 955 So. 2d at 1007-08. In addition, the proxy statement specified that "[n]o bonuses are payable unless annual net income exceeds budgeted net income." *Id.* at 1008. When HealthSouth paid Scrushy his bonuses, it mistakenly believed – based on incorrectly stated financials – that those standards had been met. According to the Alabama Supreme Court, when the company recalculated its annual earnings and determined that those standards had not been met, it was entitled to recover the compensation that it had mistakenly paid to Scrushy.

The *Scrushy* decision is the most prominent of a number of recent efforts to recover bonuses that were mistakenly paid to senior executives based upon what later were determined to be incorrect financial statements. For example, in February 2005, Nortel Networks brought suit against its former chief executive and two other officers to recover more than $10 million in bonuses that had been paid based on manipulated financial statements. A dozen other Nortel executives voluntarily returned $8.6 million in bonuses after the company's financials were restated.[731] When Congress enacted Sarbanes-Oxley in 2002, it specifically provided, in Section 304, for the forfeiture of bonuses by senior executives of a company whose financial statements, as a result of misconduct, were materially misstated. 15 U.S.C. § 7243 (2007). Although Section 304 of Sarbanes-Oxley did not create a private right of action that would enable corporations to recover bonus payments, it embodied an important statement of public policy by the United States Congress that senior executives should not be allowed to retain bonuses and other compensation they did not deserve. Similarly, the SEC staff has reportedly brought several actions to force the return of bonuses from senior executives who may have been unjustly enriched.[732]

c. New Century Officers Received Bonuses They Did Not Deserve

i. New Century's 2004 Performance Incentive Plan

Certain members of the Company's Senior Management received performance-based bonuses with respect to a six-month and 12-month performance period each year. The Officers' eligibility was determined under New Century's 2004 Performance Incentive Plan ("Plan"), which provided for various forms of compensation, including dividend equivalent rights, stock options, stock appreciation rights, restricted stock, stock bonuses and cash bonuses. Under the Plan, which was incorporated by reference into executive employment agreements, New Century

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[731] Ian Austin, *Nortel Sues 3 Ex-Officers Over Big Bonuses*, N.Y. Times, Feb. 4, 2005, at C11. One legal commentator said the Nortel suit was "on the cutting edge of developments in corporate governance." *Id.*

[732] The former chief executive of Raytheon Corporation reportedly agreed to return part of a $1.75 million bonus to settle SEC accusations over improper accounting practices. Leslie Wayne, *Ex-Raytheon Chief Agrees to Fine and Forfeit of Part of Bonus*, N.Y. Times, Mar. 28, 2006, at C11. The former chief executive of Waste Management similarly is reported to have agreed to pay $19.5 million, which included his bonus, to settle SEC claims. *Id.* In 2006, the SEC recovered $5 million from William W. McGuire, the former CEO of United Health Group, who received bonuses based on erroneous earnings figures. *SEC v. William W. McGuire*, Litig. Release No. 2754 (Dec. 6, 2007). In addition, the Office of Federal Housing Enterprise Oversight is seeking restitution of bonuses from former Fannie Mae executives under 12 U.S.C. § 4613(d)(1)(A), which specifically states that restitution should be made when an individual is unjustly enriched by certain conduct. *In re Raines, Howard and Spencer*, Notice of Charges, Office of Fed. Hous. Enter. Oversight (Dec. 18, 2006).

could grant stock or cash awards equaling a percentage of the Company's pre-tax net income (as defined and adjusted pursuant to the Plan) based upon the ratio of New Century's pre-tax net income to the Company's average stockholder's equity, as measured over a six-month and 12-month period. Generally, the higher the Company's pre-tax net income above a certain threshold, the higher the bonuses to certain officers.

New Century used the following formulas to determine bonus amounts under the Plan. For the six months ended June 30, if the pre-tax net income to stockholder equity ratio was less than nine percent, the officer was not eligible for any bonus. If the ratio was between nine percent and 14%, the officer received 1.125% (the "bonus factor") of pre-tax net income for the amount between nine percent and 14%. If the ratio was between 14% and 19%, then the officer received the bonus factor of pre-tax net income plus .75% of pre-tax net income between 14% and 19%. For a ratio above 19%, the executive got the bonus factor of pre-tax net income plus .75% of pre-tax net income and .60% of pre-tax net income in excess of 19% of total stockholder equity.

As part of a year-end review, incentive bonuses were re-calculated utilizing the same ratio of pre-tax net income to stockholder equity, but with higher thresholds. If the ratio was less than 18%, the officer received no bonus. If the ratio was between 18% and 28%, the officer was entitled to the bonus factor of pre-tax net income between 18% and 28%. If the ratio was 28% to 38%, the officer received the bonus factor of pre-tax net income plus .75% of pre-tax net income between 28% and 38%. If the pre-tax net income to stockholder equity ratio exceeded 38%, the officer received .60% of pre-tax net income, in addition to the bonus factor of pre-tax net income plus .75% of pre-tax net income.

These formulas can be depicted as follows:

	If the ratio of A to B is:	The amount of bonus is:
6 month performance period (Jan 1 - June 30)	< 9%	No bonus
	between 9% and 14%	1.125% of A in excess of 9% but not in excess of 14% of B
	between 14% and 19%	1.125% of A in excess of 9% but not in excess of 14% of B plus 0.75% of A in excess of 14% but not in excess of 19% of B
	> 19%	1.125% of A in excess of 9% but not in excess of 14% of B plus 0.75% of A in excess of 14% but not in excess of 19% of B plus 0.60% of A in excess of 19% of B
12 month performance period (Jan 1 – Dec 31)	< 18%	Nil
	between 18% and 28%	1.125% of A in excess of 18% but not in excess of 28% of B
	between 28% and 38%	1.125% of A in excess of 18% but not in excess of 28% of B plus 0.75% of A in excess of 28% but not in excess of 38% of B
	> 38%	1.125% of A in excess of 18% but not in excess of 28% of B plus 0.75% of A in excess of 28% but not in excess of 38% of B plus 0.60% of A in excess of 38% of B
Where A equals	Pre-tax net income (as defined and adjusted)	
Where B equals	Total stockholders' equity (average as defined)	

Pursuant to this formula, New Century paid out millions of dollars in inflated or unearned bonuses to members of Senior Management under the Plan. For example, in 2005, each of Cole, Morrice, Gotschall and Flanagan received performance-based bonus payments of $1,070,235 under the Plan.[733] In 2006, Cole, Morrice and Gotschall received bonuses of $693,016 each under the Plan for the six months ended June 30, 2006. These bonuses were higher than they should have been because the Company materially overstated its pre-tax net income. When the amounts of the Company's material misstatements in 2005 and 2006 are taken into account, pre-tax net income would have been reduced significantly. Consequently, 2005 bonuses paid to these members of senior Management would have been reduced considerably and bonuses paid for the six months ended June 30, 2006 would have been eliminated altogether.

Specifically, for 2005, the performance-based bonuses paid to Cole, Gotschall, Morrice and Flanagan should have been no more than $354,736 each, a total reduction of almost $2.9

[733] Flanagan also received an additional $50,000 cash payout in 2005.

million.[734] Cole, Gotschall and Morrice should have been paid no bonuses in 2006, a total reduction of almost $2 million.[735]

ii. Quarterly Performance-Based Bonus Plans

New Century also paid quarterly bonuses to certain members of Senior Management and others, including Cloyd, Dodge, Meola, Eckroth and Theologides. Net income was a factor in determining these bonuses. For example, Kevin Cloyd, the head of Secondary Marketing, received quarterly bonuses totaling over $1.5 million in 2005. Cloyd's bonuses apparently were based principally upon New Century's loan production volume, net income and operating margin results relative to pre-established targets.

After taking into account the impact of New Century's material misstatements of its net income, the Examiner has determined that the quarterly bonuses paid to Cloyd were $351,098 greater than they should have been in 2005. Expressed as a percentage, the bonuses paid to Cloyd for 2005 were 130% larger than they should have been.

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[734] For 2005, the ratio would have decreased from 23% to 20% when the material misstatement is considered. Although, according to the chart above, the bonus factor (1.125%) for these officers would have remained the same (because the ratio of pre-tax net income to the average stockholders' equity was still between 18% and 28% percent at year end), it would have produced significantly smaller bonuses because the factor would have been applied to significantly lower pre-tax income.

[735] In 2006, the ratio of pre-tax net income to the average stockholders' equity would have decreased from 12% to eight percent when the material misstatement is considered. According to the chart above, if the ratio is less than nine percent for a six month performance period, the officer is not eligible to receive a bonus.

The effect of the Company's misstatement of net income with respect to this example can be illustrated as follows:

At December 31, 2005		Budget	Actual	Revised Actual	% (revised)	Bonus payout
Q1	Production	9,563,453,000	10,251,567,000	10,251,567,000	107%	159,293
	Net Income	61,834,000	84,760,000	75,220,000	122%	272,250
Q2	Production	11,323,526,000	13,444,171,000	13,444,171,000	119%	178,091
	Net Income	81,468,000	95,079,000	85,539,000	105%	236,250
Q3	Production	12,679,116,000	15,856,978,000	15,856,978,000	125%	187,595
	Net Income	172,266,000	124,217,000	114,677,000	67%	-
Q4	Production	14,249,691,000	13,170,734,000	13,170,734,000	92%	138,642
	Net Income	215,401,000	120,950,000	111,410,000	52%	-
	Bonus – Cloyd					**1,172,121**
	Bonus paid per Board Minutes					1,523,219
	Difference					**(351,098)**
	Reported bonus % compared to revised					**130%**
Revised actual uses tax-effected misstatement divided into 4 to determine quarterly adjustment						
	[$63.6 million less tax at 40% = $38.16 m / 4 = $9.54 m adjustment each quarter][736]					

As this example illustrates, the dollar amount disparity between the quarterly bonuses New Century paid to executives during 2005-2006 and the maximum quarterly bonuses the Company should have paid is substantial.

d. New Century's Officers Should Return the Bonuses They Did Not Deserve

The Examiner has determined that the estates possess potential causes of action against the Officers who received the bonuses described above – as well as against any other Officers who received bonuses or other compensation that were paid based upon net income figures that were misstated – to require the return of those bonuses under principles of unjust enrichment. Just as the Alabama courts required Richard Scrushy to return bonuses he did not deserve, the

[736] To determine the effect of the material misstatement at year end 2005 on Cloyd's quarterly bonuses paid in 2005, the Examiner divided the misstatement into four equal parts.

Examiner believes it would be "unconscionable" for former New Century officers to retain bonuses or any other compensation they did not deserve, regardless of whether they participated in any wrongdoing.

2. The Bonuses Improperly Paid to New Century Officers May Also Be Recoverable Under Section 548 of the Bankruptcy Code

The bonuses that were improperly paid to New Century Officers may also be recoverable as fraudulent conveyances under Section 548 of the Bankruptcy Code.[737] Section 548 (B)(ii)(IV) of the Bankruptcy Code and changes made to Section 548(a)(1) of the Bankruptcy Code, were added in 2005 "to enhance the recovery of avoidable transfers and excessive prepetition compensation, such as bonuses, paid to insiders of a debtor." H.R. Rep. No. 109-31, pt. 1, at 154 (2005), *as reprinted in* E-2 *Collier on Bankruptcy*, Pt. 10(b) (Alan N. Resnik & Henry J. Sommer eds. 15th ed. revised 2007). To satisfy the requirements of Section 548(B)(ii)(IV), a debtor must have received less than reasonably equivalent value and the transfer must have been

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[737] Section 548(a) of the Bankruptcy Code provides:

> (a)
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> (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily -- . . .
>
> (B)
>
> (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii)
>
> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
>
> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548(a) (2007).

made (i) to an insider, (ii) under an employment agreement and (iii) not in the ordinary course of business. No showing concerning a debtor's financial condition is required under Section 548(B)(ii)(IV).

Because New Century's actual net income during 2005 and 2006 was less than the reported net income that purportedly justified the incentive bonuses paid, the Debtors did not receive reasonably equivalent value in return for bonuses paid to former Officers of New Century who were statutory insiders, as defined in 11 U.S.C. § 101(31)(B)(ii) (2007). Although Section 548(B)(ii)(IV) does not define the term "not in the ordinary course of business," it is appropriate to look for guidance to interpretations of this phrase in other sections of the Bankruptcy Code.

In *In re Roth American Inc.*, 975 F.2d 949 (3d Cir. 1992), a case involving the interpretation of the phrase "ordinary course of business" as used in Section 363 of the Bankruptcy Code, the Third Circuit explained that

> [T]he courts have engaged in a two-step inquiry for determining whether a transaction is in "the ordinary course of business": a "horizontal dimension" test and a "vertical dimension" test . . . . The inquiry deemed horizontal is whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry . . . . For example, "raising a crop would not be in the ordinary course of business for a widget manufacturer because that is not a widget manufacturer's ordinary business." . . . The inquiry deemed vertical (more appropriately characterized as the creditor's expectation test) analyzes the transactions "'from the vantage point of a hypothetical creditor and [the inquiry is] whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit.'" . . . Under this test, "the touchstone of 'ordinariness' is . . . the interested parties' reasonable expectations of what transactions the debtor in possession is likely to enter in the course of its business." . . . The primary focus thus is on the debtor's pre-petition business practices and conduct, although a court must also "consider the changing circumstances inherent in the hypothetical creditor's expectations."

In re Roth American Inc., 975 F.2d at 952-53 (citations omitted).

Although there is no case law directly on point, the estates potentially could assert that New Century's payment of bonuses to Officers in 2005 and 2006 based upon misstated net income figures is not within the reasonable expectations of creditors and, therefore, was not in

the ordinary course of New Century's business. As a result, the Examiner believes the estates may have a cause of action to recover those bonuses under Section 548(B)(ii)(IV) of the Bankruptcy Code.

E. Potential Causes of Action Against Former New Century Officers or Directors for Breach of Duty

The Examiner has considered other potential causes of action that possibly could be asserted by the estates against former Officers and current or former Directors of New Century. These potential claims, each of which requires satisfaction of a substantial legal standard to support liability, are summarized as follows.

1. Breach of Fiduciary Duty and Corporate Waste

As discussed above, Maryland law would apply to claims by the estates against Officers and Directors of New Century for breach of fiduciary duty. Maryland has codified the duties of directors of Maryland corporations. *See* Md. Code Ann., Corps. & Ass'ns § 2-405.1(a) (LexisNexis 2008) ("A director shall perform his duties . . . [i]n good faith[,] [i]n a manner he reasonably believes to be in the best interests of the corporation[,] and [w]ith the care that an ordinary prudent person in a like position would use under similar circumstances.").

No statute and only a few reported judicial decisions have contemplated directly the fiduciary duties of officers. Maryland has long held, however, that directors and officers of a corporation stand in a fiduciary relationship to their corporation. *See Merchs. Mortg. Co. v. Lubow*, 339 A.2d 664, 669 (Md. 1975); *see also In re Walt Disney Co. Derivative Litig.*, No. 15452, 2004 Del. Ch. LEXIS 132, at *14 (Del. Ch. Sept. 10, 2004) ("To date, the fiduciary duties of officers have been assumed to be identical to those of directors.").

a. Principles Governing Fiduciary Duties of Directors

i. Decision-making by Directors

Since its enactment in 1976, there have been no authoritative Maryland cases interpreting the Maryland statute governing conduct by corporate directors. *See* James J. Hanks, Jr., *Maryland Corporation Law* §164. Nonetheless, Section 2-405.1(a) specifies certain elements which serve to define and circumscribe the liability of corporate directors. For purposes of this Final Report, those elements may be summarized as follows:

(a) A director's decisions must be made in "good faith"

"Good faith", as used in § 2-405.1(a)(1), is the absence of any desire to obtain a personal benefit or a benefit for some person other than the corporation. Good faith is generally synonymous with what is referred to in other jurisdictions as the duty of loyalty or the duty of fair dealing. *See United Wire, Metal & Mach. Health & Welfare Fund v. Board of Sav. & Loan Ass'n Comm'rs*, 558 A.2d 379, 383 (Md. 1989) (noting that § 2-405.1(a)'s good faith and reasonable belief requirements cover many requirements that would be called the duty of loyalty in the absence of the statute). In addition, the duty of good faith includes a duty of candor with the stockholders. *See Parish v. Maryland & Va. Milk Producers Ass'n*, 242 A.2d 512, 539 (Md.)) 1968) (stating that the duty of candor means revealing to the stockholders all material facts about a major transaction or any other important matter involving the corporation).

(b) A director must "reasonably believe" that his decisions are in the "best interests of the corporation"

"Reasonable belief," as used in § 2-405.1(a)(2), means that there must be some rational basis for the director's action, that the director must have knowledge of that basis, and that his performance must be based on that knowledge. *See Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 633-34 (D. Md. 1982).[738] The reasonable belief requirement does not authorize judicial review of the *wisdom* of the director's action or failure to act, but rather the process of coming to her decision.[739] In order for a decision to be reasonable, it must be based on adequate information. *See NCR Corp. v American Tel. & Tel. Co.*, 761 F. Supp. 475, 491 (S.D. Ohio 1991) (applying Maryland law) (stating that [a]ny decision undertaken on the basis of insufficient knowledge is inherently unreasonable). Additionally, a court will determine whether a director satisfies the standard of conduct at the time of his act or omission rather than in hindsight. *Cf. Gay v. Md. Deposit Ins. Fund*, 521 A.2d 1205, 1213 (Md. 1987).

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[738] Where a director is confronted with two possible courses of action, both rational, the fact that his or her choice of one of them later turns out to have been less advantageous to the corporation than the other will not mean, especially in the absence of any showing of bad faith, that he or she did not reasonably believe she was acting in the corporation's best interests at the time. *See Cummings v. United Artists Theatre Circuit, Inc.*, 204 A.2d 795, 802 (Md. 1964).

[739] Courts generally may not interfere with or second-guess the business decisions made by directors of a corporation in their management of the corporation. *See, e.g., Mountain Manor Realty, Inc. v. Buccheri*, 461 A.2d 45, 50 (Md. Ct. Spec. App. 1983).

"Best interests of the corporation," as used in § 2-405.1(a)(2), means that a director is required to act in a manner he reasonably believes to be in the best interests of the corporation, rather than the best interests of any stockholder or group of stockholders. *See Werbowsky v. Collomb*, 766 A.2d 123, 133 (Md. 2001).

(c) A director's decisions must be made with the care of an "ordinary prudent person" in similar circumstances

A board of directors should have available to it information material to the decision and should have some opportunity to ask questions of management and to meet and discuss the matter among themselves. The "ordinary prudent person standard," as used in § 2-405.1(a)(3), is applied in the context of a like position under similar circumstances. The standard of care that is expected is the same standard of care that an ordinary prudent director would give as he engages in the process of making decisions. In addition, the requirements of § 2-405.1(a)(3) codify the pre-existing gross negligence standard. *See Parish*, 242 A.2d at 540; *see also Billman v. Md. Deposit Ins. Fund Corp.*, 593 A.2d 684, 697 (Md. Ct. Spec. App. 1991) (noting that Maryland courts have continued to require proof of gross or culpable negligence as the basis for recovery of money damages). Former officers and current or former Directors of New Century may be liable for breach of fiduciary duty only if their conduct involved "gross or culpable negligence," bad faith or fraud. *See Froelich v. Senior Campus Living LLC,* 355 F.3d 802, 810-11 (4th Cir. 2004) (applying Maryland law); *See also Stanziale v. Nachtomi (In re Tower Air, Inc.),* 416 F.3d 229, 239 (3d Cir. 2005) (applying Delaware law, the court observed that irrational decision-making may constitute gross negligence).

ii. Oversight Duties of Directors

In addition to liability for lack of care in authorizing or making decisions, directors or officers may violate the duty of care through lack of attention or failure adequately to supervise officers or employees or other neglect of duty. While a decision to delegate generally will be protected by the business judgment rule, *see Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 943 (Del. 1985), the business judgment rule does not apply to a failure to take action where "directors have either abdicated their functions or absent a conscious decision, failed to act." *Aronson v. Lewis*, 473 A2d 805, 813 (Del. 1984), *overruled on other grounds, Brehm v. Eiser, 746 A.2d 244 (Del. 2000).*

b. Principles governing fiduciary duties of corporate officers

In Maryland, corporate officers are judged under general agency principles. *See* James J. Hanks, Jr., *Maryland Corporation Law* § 198.6 (Aspen 2006). The principal to whom officers owe their duties is the corporation. *See id.*; *Md. Metals, Inc. v. Metzner*, 382 A.2d 564, 568 (Md. 1987) (stating that the court has "read into every contract of employment an implied duty that an employee act solely for the benefit of his employer in all matters within the scope of employment, avoiding all conflicts between his duty to the employer and his own self-interest"). General agency principles include the exercise of reasonable care and skill in the performance of the officer's responsibilities as well as the duties of loyalty, good faith and candid disclosure. *See Hale Trucks of Md., LLC v. Volvo Trucks N. Am., Inc.*, 224 F. Supp. 2d 1010, 1023 (D. Md. 2002).[740]

A plaintiff must demonstrate the following elements to hold an officer personally liable for a breach of fiduciary duty: (1) a breach of the officer's duty of care (or of his duty to inform the Board of material matters); [741] (2) that "contributed to, or helped bring about;" (3) an injury to the corporation. *Tedrow v. Deskin*, 290 A.2d 799, 803 (Md. 1972). Officers of a corporation are personally liable for the torts in which they actively participated, even if the tort was committed in the name or on behalf of the corporation. *See, e.g.*, *Steigerwald v. Bradley*, 229 F. Supp. 2d 445, 451 (D. Md. 2002).

c. Corporate waste

Maryland law also recognizes that corporate officers and directors may be held individually liable for permitting corporate assets to be wasted. Such a claim sometimes is treated as an extension of a claim for breach of fiduciary duty. *See, e.g.*, *Kann v. Kann*, 690 A.2d 509, 521 (Md. 1997) ("[o]ur holding means that identifying a breach of fiduciary duty will be the beginning of the analysis, and not its conclusion"). The legal standard with respect to liability for corporate waste is high. Absent self-dealing or self-enrichment, corporate officers or directors may be liable for corporate waste only as a consequence of "gross or culpable

[740] An agent has a duty to inform its principal of material matters relevant to the agency. Restatement (Second) of Agency § 381 (1958). An officer's duty to inform the board of directors can be inferred from the Maryland statutory requirement that the corporation be managed by or under the direction of the board of directors, Md. Code Ann., Corps. & Ass'ns § 2-401(a), and that, in performing his or her duties, a director may rely on information, opinions, reports, or statements (including any financial statement or other financial data), prepared or presented by: (1) an officer or employee of the corporation; (2) legal counsel, a certified public accountant or other professional or expert; and (3) a committee of the board on which the director does not serve.

[741] *See, e.g.*, Restatement (Second) of Agency § 381.

negligence." *Bart Arconti & Sons, Inc. v. Ames-Ennis, Inc.*, 340 A.2d 225, 236 (Md. 1975) ("While we have held that the directors of a corporation may be held individually liable for permitting corporate assets to be wasted, this rule applies only where this occurs in consequence of 'gross or culpable negligence.'") (citations omitted); *Edge Partners, L.P. v. Dockser*, 944 F. Supp. 438, 442 (D. Md. 1996) (court sustained cause of action for gross negligence and waste of corporate assets, ruling "Plaintiff has alleged sufficient facts to state a cause of action for gross negligence and waste of corporate assets").

2. Potential Fiduciary Lapses by New Century Officers and Directors

The Examiner investigated potential fiduciary lapses by New Century Officers and Directors, including instances where action or inaction by New Century Officers and Directors might constitute corporate waste. Given the operation of the business judgment rule, statutory limitations on liability for Directors under Maryland law, and provisions contained in the Company's organizational documents and certain employment agreements, the Examiner understands that the estates would have to demonstrate gross negligence and possibly self-dealing or affirmative misconduct on the part of the Officers or Directors to recover for these apparent lapses. In light of these rigorous legal standards, the Examiner has not included a detailed discussion of such potential causes of action in this Final Report. Nonetheless, because these matters raise some significant questions, and because representatives of the estates may wish to consider more thoroughly possible allegations or claims regarding these matters, the Examiner believes it is important to summarize certain of the potential claims he had considered.

As described in this Final Report, the Examiner found certain circumstances in which members of New Century's Management, including Senior Management and possibly members of its Board of Directors, acted in a manner that appears to reflect departures from a standard of reasonable care. These circumstances include, but are not limited to, the following conduct or activities by former Officers or Directors of New Century:

- altering the methodology for the calculation of the repurchase reserve with respect to the second and third quarters of 2006 in a manner that was inconsistent with GAAP and that caused the reserve to be understated by 178% and 1000% for those periods, respectively ;
- failing to track properly and account for the backlog of loan repurchase demands received by the Company, resulting in an underreporting of repurchase exposure and a materially inadequate reserve;

- failing to update assumptions and to increase the discount rates used by New Century to value residual interests, which resulted in an overvaluation of residual interests throughout the relevant period and a material overstatement of pre-tax earnings;
- overstating the LOCOM valuation account by more than 100% with respect to 2005 and more than 200% for the period ended March 31, 2006;
- failing to ensure the adequacy of systems and controls respecting repurchase reserves, the LOCOM valuation account, residual interest valuations and the other accounting areas where the Examiner identified errors;
- guiding New Century toward the origination of higher risk loan products without taking prudent steps to address those risks in a meaningful manner, especially after New Century identified the poor delinquency rates of many of the higher risk products;
- failing to act, for at least several years, to curb the kickouts, including "no brainer" loan rejections based upon incomplete loan files, which cost New Century millions of dollars;[742] and
- causing New Century to repurchase millions of dollars worth of its own stock amidst growing liquidity concerns, aggravated market conditions, rising EPDs and a dramatic increase in loan repurchase exposure.

3. Potential Defenses to Breach of Duty Claims on Behalf of the Estates

The following categories of defenses might be asserted with respect to claims brought on behalf of the estates for breach of fiduciary duty or corporate waste. As noted above, these defenses impose substantial limitations on the ability of the estates to assert possible breach of duty claims against Officers or Directors of New Century.

a. The Business Judgment Rule

Maryland courts apply the business judgment rule when determining whether directors have complied with their fiduciary duties. The business judgment rule creates a presumption that directors acted in good faith. *See Zimmerman*, 800 F.2d at 392 (interpreting Maryland law). In Maryland, § 2-405.1(e) of the Corporation Code codifies the business judgment rule by creating a presumption in favor of a director's acts. Md. Code Ann., Corps. & Ass'ns § 2-405.1(e) (LexisNexis 2008); *see Werbowsky*, 766 A.2d at 138 n.7.[743] The business judgment rule prohibits judicial review of business decisions made by directors that turn out to be mistakes of

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[742] The failure to take action to reduce meaningfully this drain on resources might constitute "irrational decisionmaking" sufficient to support a claim. *Tower*, 416 F.3d at 241.

[743] "Presumption of satisfaction. – An act of a director of a corporation is presumed to satisfy the standards of subsection (a) of this section." Md. Code Ann., Corps. & Ass'ns § 2-405.1(e).

judgment. *See Parish* 242 A.2d at 540. However, the business judgment rule does not protect business decisions of directors that are the result of gross or culpable negligence. *Id.* If a director did not comply with each of the three requirements embodied within the standard of care required of directors (acting in good faith, in the best interests of the corporation, and with due care) of § 2-405.1(a), then the director may be liable without regard to the merits of the decision. *See, e.g., Black v. Fox Hills N. Cmty Ass'n*, 599 A.2d 1228, 1231 (Md. Ct. Spec. App. 1992).

The business judgment rule has been applied primarily in the context of director conduct. While few cases show the extent of the rule's applicability to decisions of non-director officers, some cases suggest that decisions of officers should be governed by the rule. *See, e.g., Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971) ("the decision of executive officers may also come within the [business judgment rule]").

b. Unclean Hands

There appears to be some disagreement under Maryland law whether the defense of unclean hands may be applied only to bar recovery in actions at equity or at both equity and at law. *Compare Adams v. Manown*, 615 A.2d 611, 623-24 (Md. 1992) and *Hicks v. Gilbert*, 762 A.2d 986, 989-90 (Md. Ct. Spec. App. 2000). "The doctrine is not for the protection of the parties to a lawsuit, but rather, for the protection of the courts -- the idea being that judicial integrity is endangered when judicial powers are interposed to aid persons whose very presence before a court is the result of some fraud or inequity." *Manown v. Adams*, 598 A.2d 821, 824 (Md. Ct. Spec. App. 1991) (citation omitted), *vacated on other grounds*, *Adams*, 615 A.2d 611. Where there is evidence of "willful wrongdoing in relation to the controversy before it," the doctrine of unclean hands permits the court (at its discretion) to deny relief to parties who have participated in the wrongdoing. *Manown*, 598 A.2d at 825.

c. In Pari Delicto

Under Maryland law, when the parties have participated in fraudulent or illegal conduct, they are considered to be *in pari delicto*, and one party may not maintain suit against another party "directly arising out of the misconduct." *See Adams*, 615 A.2d at 623 (Chasanow, J., dissenting) (citation omitted). If the wrongdoing of a director or officer is imputed to the corporation, the doctrine of *in pari delicto* may bar suit on behalf of a bankruptcy estate, unless claims are asserted on behalf of the estate as an innocent victim of the wrongdoing. *See id.* at

624 (holding that the defense of *in pari delicto* did not apply because the trustee was pursuing the rights of mortgage lenders that were assigned to the estate).

d. Right to Rely on Information Provided by Others

Pursuant to § 2-405.1, in performing his or her duties, a director may rely on information, opinions, reports, or statements (including any financial statement or other financial data), prepared or presented by: (1) an officer or employee of the corporation; (2) legal counsel, a certified public accountant or other professional or expert; and (3) a committee of the board on which the director does not serve. Md. Code Ann., Corps. & Ass'ns § 2-405.1. The director reasonably must believe in the presenter's reliability, competence and expertise on the relevant subject. With respect to information from a committee, it must be "as to a matter within [the committee's] designated authority [and] the director [must] reasonably [believe] the committee to merit confidence." *See* § 2-405.1(b).

A director's reliance upon the competent information and advice of others, as set forth in subsection (b), is a defense to allegations that his or her performance did not meet the requirements of § 2-405.1. *See, e.g., Yost v. Early*, 589 A.2d 1291, 1299 (Md. Ct. Spec. App. 1991); *see also* Md. Code Ann., Corps. & Ass'ns § 2-405.1(c). The burden of proof is upon the defendant director to demonstrate that he or she met the requirements of § 2-405.1(b). *Yost*, 589 A.2d at 1299.

e. Indemnification and Limitation of Liability Provisions

New Century Officers and Directors may also seek to assert defenses to causes of action asserted by the estates based upon rights to indemnification and limitations on liability contained in the Company's charter, bylaws and employment agreements.

i. Statutory Framework for Indemnification and Limitations on Liability

In Maryland, indemnification of a corporation's directors and officers is governed by Section 2-418 of the Corporation Code. *See* Md. Code Ann., Corps. & Ass'ns § 2-418(a)(3) & (j)(1) (LexisNexis 2008). Unless limited by charter, indemnification of expenses incurred by a director or officer in connection with a proceeding is mandatory if (1) a director or officer has been successful on the merits or otherwise in the defense of any proceeding covered by the indemnification statute or (2) a court orders indemnification under specific circumstances set forth in the statute. *See id.* § 2-418(d). In the absence of a successful defense of the proceeding by a director or officer or an applicable court order, indemnification is permissive unless it is

established that an act or omission by a director or officer: (1) was material to the matter giving rise to the proceeding, and (a) was committed in bad faith or (b) was the result of deliberate dishonesty; or (2) resulted in improper personal benefit to the director; or (3) in the case of a criminal proceeding, the director had reasonable cause to believe the act or omission was unlawful. *See id.* § 2-418(b). A corporation may not indemnify a director, officer, employee or agent in "any proceeding charging improper personal benefit to the director [or officer, employee or agent], whether or not involving action in the [individual's] official capacity, in which the [individual] was adjudged to be liable on the basis that personal benefit was improperly received." *See id.* § 2-418(c).

Since 1988, Maryland corporations have been permitted to adopt a charter that further limits the liability of directors and officers of the corporation or its stockholders for money damages, so long as any such limitation does not limit the director's or officer's liability if the director or officer has actually received an improper benefit or engaged in active and deliberate dishonesty. *See* Md. Code Ann., Corps. & Ass'ns § 2-405.2 (LexisNexis 2008) and Md. Code Ann., Cts. & Jud. Proc. § 5-418 (LexisNexis 2008). To the extent a corporation's charter includes a provision limiting director and officer liability and there is no allegation that the director's or officer's conduct falls within one of the two exceptions, a court may dismiss any claim against the director or officer by the corporation or its stockholders for money damages arising out of such conduct. *Grill v. Hoblitzell*, 771 F. Supp. 709, 712 (D. Md. 1991) (dismissing a stockholder derivative action against the directors of a Maryland corporation with a director exculpation provision in its charter, in part because the stockholders' boilerplate allegations of waste and mismanagement did not constitute "situations involving 'active and deliberate dishonesty' or the actual receipt of an improper benefit").

ii. Indemnification or Liability Limitations in New Century's Corporate Documents

(a) Articles of Amendment and Restatement

Article VIII of New Century's Articles of Amendment and Restatement, dated September 30, 2004, provides that Directors and Officers (including former Directors and Officers) are entitled to indemnification "in the manner and to the fullest extent permitted by law" when that individual "is or was a party to, or is threatened to be made a party to, any threatened, pending or completed action, suit or proceedings, whether or not by or in the right of the Corporation, and whether civil, criminal, administrative, investigative or otherwise."

Article IX states broadly that Directors and Officers shall not "be personally liable to the Corporation or its stockholders, or any of them, for money damages," to the fullest extent permitted under Maryland law.

(b) New Century's Bylaws

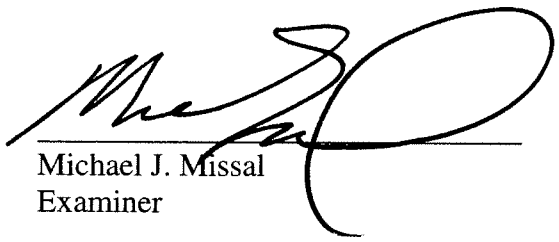
New Century's Amended and Restated Bylaws ("Amended Bylaws"), dated September 30, 2004, provide broad rights of indemnification, akin to those contained in the Articles of Incorporation and the Articles of Amendment and Restatement. The Amended Bylaws state that the Company will indemnify, to the maximum extent permitted by applicable law, without requiring a preliminary determination of the ultimate entitlement to indemnification, reasonable expenses in advance of final disposition of a proceeding to a current or former director or officer who is made a party to or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding (including civil, criminal, administrative or investigative matters).

(c) Employment Agreements

Some employment agreements for New Century Officers and employees also contain provisions with respect to indemnification. The standard formulation incorporated by New Century in employment agreements for Senior Management provides for indemnification to the extent permitted by law, applicable statutes, the Articles of Incorporation, Bylaws or Company Resolutions, and obligates New Century to indemnify the Officer against "liability or loss arising

out of [his or her] actual or asserted misfeasance or nonfeasance in the performance of [his or her] duties or out of any actual or asserted wrongful act against, or by, the Company including but not limited to judgments, fines, settlements and expenses incurred in the defense of actions, proceedings and appeals."

Respectfully submitted,



Michael J. Missal
Examiner

February 29, 2008

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Appendix A
Often Used Acronyms or Abbreviations

Acronym or Abbreviation	Definition
AARMR	America Association of Residential Mortgage Regulatory
ABS	Asset Based Securities
AICPA	American Institute of Certified Public Accountants
ALCO	Asset and Liability Committee
ALL	Allowance for Loan Losses
AOCI	Accumulated Other Comprehensive Income
ARM	Adjustable Rate Mortgage
AU	AICPA Professional Standards, Audit Risk and Materiality in Conducting an Audit
CAAT	Computer Assisted Audit Technique
CAE	Chief Audit Executive
C-BASS	Credit-Based Asset Servicing and Securitization
CDR	Conditional Default Rate
CE	Credit Enhancement
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CFRA	Center for Financial Research and Analysis
CLTV	Combined Loan-To-Value
CMBS	Commercial Mortgage-Based Securities

Acronym or Abbreviation	Definition
CMO	Collateralized Mortgage Obligation
COO	Chief Operational Officer
COSO	Committee of Sponsoring Organizations of the Treasury Commission
CPR	Constant Prepayment Rate
CSBS	Conference of State Bank Supervisors
CSH	Common Shareholder
DER	Dividend Equivalent Rights
DIG	Derivatives Implementation Group
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
DPP	Department of Professional Practice
DTI	Debt-To-Income
EDF	Euro Dollar Futures
EITF	Emerging Issues Task Force
EMC	Executive Management Committee
EPD	Early Payment Default (default on any of the first three borrower loan payments)
EPS	Earnings Per Share
EVP	Executive Vice President
E&Y	Ernst & Young
FASB	Financial Accounting Standards Board
FASCON	FASB Statement on Financial Accounting Concepts No.

Acronym or Abbreviation	Definition
FDR	Financial Derivatives Resource Group
FHA	Federal Housing Authority
FICO	A credit score developed by Fair Isaac Corporation.
FIN	Financial Accounting Standards baord Interpretation No.
FPD	First payment default
FRM	Financial Risk Management
FRM	Fixed Rate Mortgage
FRR	Financial Reporting Release
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GOS	Gain On Sale
GSE	Government Sponsored Entities
Heller	Heller Ehrman LLP
HELOC	Home Equity Line of Credit
HFI	Held for Investment
HFS	Held For Sale
IIA	Institute of Internal Auditors
IO	Interest Only
IRLC	Interest Rate Lock Commitments
IRM	Information Resources Management
IT	Information Technology

Acronym or Abbreviation	Definition
ITGC	Information Technology General Controls
K&L Gates	Kirkpatrick & Lockhart Preston Gates Ellis LLP
KPMG	KPMG LLP
LHFI	Loans Held For Investment
LHFS	Loans Held For Sale
LIBOR	London Interbank Offered Rate
LOCOM	Lower of Cost or Market
LTB	Loan Trial Balance
LTV	Loan To Value
MBS	Mortgage-Backed Securities
MSR	Mortgage Servicing Rights
MTM	Mark To Market
NCCC	New Century Capital Corp.
NCMC	New Century Mortgage Corporation
NIMS	Net Interest Margin Securities
NYSE	New York Stock Exchange
OBS	On Balance Sheet
OC	Over Collateralization
OCI	Other Comprehensive Income
OMM	O'Melveny & Myers LLP
PCAOB	U.S. Public Accounting Oversight Board

Acronym or Abbreviation	Definition
P&L	Profit and Loss
PMI	Private Mortgage Insurance
PwC	Pricewaterhouse Coopers LLP
QA	Quality Assurance
QRS	Qualified REIT Subsidiary
RBC	Royal Bank of Canada
REIT	Real Estate Investment Trust
REMIC	Real Estate Mortgage Investment Conduit
REO	Real Estate Owned
RESPA	Real Estate Settlement Procedures Act
RMBS	Residential Mortgage Backed Security
ROE	Return on Equity
RoSM	Risk of Significant Misstatement
SAB	SEC Staff Accounting Bulletin
SAS	Statement on Auditing Standards
SEC	U.S. Securities and Exchange Commission
SFG	Structured Finance Group
SIC	Special Investigation Committee of the New Century Audit Committee
SOX	Sarbanes-Oxley Act of 2002
SPD	Second Payment Default
SPE	Special purpose entity

Acronym or Abbreviation	Definition
SVP	Senior Vice President
TDP	Third Payment Default
T&R	Time and Responsibility
TRA	Tax Reform Act of 1980
TRS	Taxable REIT Subsidiary
UPB	Unpaid Principal Balance
VA	Department of Veterans Affairs
VBA	Microsoft Visual Basic for Applications
VP	Vice President
WACLTV	Weighted Average Combined Loan to Value Ratio

Appendix B
Important New Century and KPMG Personnel

New Century

Name	Position
Marilyn Alexander	Independent Director (mid-April 2005)
George Arambula	Vice President, Internal Audit
Paul Atkinson	Vice President, Risk Solutions
Eric Bachelor	Senior Trading Analyst
Mark Bernstein	Program Type Manager
Tajvinder Bindra	Executive Vice President (after November 2006)
Harold Black	Independent Director
Ron Brown	AVP, Internal Audit
Ron Brown	Secondary Marketing, Repurchase Desk
Richard Cimino	President, Loan Servicing
Kevin Cloyd	Executive Vice President and President of New Century Capital Corp.
Dan Coakley	Vice President, Credit and Operations
Robert Cole	Chairman of the Board and Chief Executive Officer
Rick Collins	Investor Reporting Manager
Rodney Colombi	Executive Vice President, Corporate Finance
Patti Dodge	Executive Vice President, Chief Financial Officer (until November 2006)
Trevor Drummond	Accounting Manager
Joseph Eckroth, Jr.	Executive Vice President, Chief Operating Officer (2006)
David Einhorn	Independent Director (since March 2006)
Holly Etlin	Chief Restructuring Officer (Alix Partners)
Christine Fidler	Vice President, Corporate Finance
Patrick Flanagan	President, New Century Mortgage Corp. (until December 2005)
Frederic Forster	Independent Director
Amanda Fowler	Assistant Vice President, Investor Relations
Carol Franchi	Assistant Vice President, Loan Accounting Manager
Lou Garday	Tax Director
Jeffrey Goldberg	Vice President, Treasurer
Edward Gotschall	Vice Chairman-Finance (through June 2006)
John Hatch	Senior Analyst, Secondary Marketing
John Hedlund	Senior Vice President, Corporate Operations
Jennifer Jewett	Vice President, Corporate Counsel, Corporate Secretary
Lenice Johnson	Senior Vice President, Corporate Operations (beginning June 2006)
David Kenneally	Senior Vice President, Controller
Robert Lambert	Senior Vice President, Leadership and Organizational

Name	Position
	Development
Donald Lange	Independent Director
Tim Lee	Underwriter
Steve Lemon	Executive Vice President, East Coast Wholesale
Robert Lent	Vice President, Investor Relations
Warren Licata	Senior Vice President, Secondary Marketing and Capital Markets
Mary Malloy	Vice President, Hedging
Carrie Marrelli	Vice President, Investor Relations
Monica McCarthy	Senior Vice President, Assistant General Counsel
Lois McDermott	Risk Manager
William McKay	Senior Vice President, Mortgage Operations
Anthony Meola	Executive Vice President, Loan Production (beginning May 2006)
Evan Mitnick	Senior Vice President, New Century Capital Corporation
Brad Morrice	Vice Chairman, President and Chief Operating Officer (through June 2006), Chief Executive Officer (from July 2006)
Matthew Mullins	Associate Trader
Yury Pyatigorsky	Vice President, Corporate Development
William Popejoy	Independent Director
Rick Rhinehart	Vice President, Secondary Marketing
Michael Sachs	Independent Director
Tony Sanchez	Vice President, Controller
Music Sprouse	Cash Management Manager
Randy Stewart	Executive Vice President, Home123 Capital Markets
Stergios ("Terry") Theologides	Executive Vice President, Corporate Affairs and General Counsel
Jonathan Threadgill	President, Retail Prime
Joseph Tortorelli	Assistant Vice President, Corporate Counsel
Donna Walker	Vice President, Financial Reporting
Karl Weiss	Senior Vice President, Capital Markets
Colleen Wolf	Senior Vice President, Chief Information Officer
Paul Zalle	Senior Vice President, Internal Audit
Richard Zona	Independent Director

KPMG

Name	Position
Athena Chan	KPMG Manager, New Century Engagement
Christina Chinn	KPMG Associate, New Century Engagement
Debbie Biddle	KPMG Senior Associate, New Century Engagement
Fiona Liang	KPMG Senior Manager, New Century Engagement
John Donovan	KPMG Partner, New Century Engagement
John Klinge	KPMG Partner, FRM/FDR
Justin Ayre	KPMG Senior Manager, FRM/FDR
Kurt Kurimsky	KPMG Partner
Marc Macaulay	KMPG SEC concurring partner, New Century Engagement
Mark Kim	KPMG Senior Manager, New Century Engagement
Patrick Kinsella	KPMG Partner, New Century Engagement
Ray Munoz	KPMG Manager, FRM/FDR
Ryan Beckstrom	KPMG Senor Associate, New Century Engagement
Scott Carnahan	KPMG SFG Partner, SFG
Scott London	KPMG Partner, In-charge Audit Los Angeles
Tara Hatanaka	KPMG Senior Manager, New Century Engagement
Terri Iannaconi	KPMG Partner, DPP
Veronica Wong	KPMG Manager, New Century Engagement
Ron Yuval	KPMG Senior Manager, SFG