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Once Trusted Mortgage Pioneers, Now Scrutinized

By Michael Moss and Geraldine Fabrikant
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Corrections Appended

"We are team-oriented, highly ethical, extremely competitive, profit-oriented, risk-averse, consumer-focused, and we try as much as possible to squeeze out any ego. Hubris is the beginning of the end."

— Herbert Sandler, June 2005

SAN FRANCISCO — Herbert Sandler, the founder of the Center for Responsible Lending, is standing in his bayfront office watching a DVD that trains brokers to pitch mortgages by extolling the glories of the real estate boom.

The video reeks of hucksterism, and it infuriates Mr. Sandler.

"I would not have approved that!" he declares. "I don't think we should be selling our loans based on home prices continuing to go up."

But the DVD was produced in 2005 by a mortgage lender that Mr. Sandler and his wife, Marion, ran at the time: World Savings Bank. And the video was a small part of a broad and aggressive effort by their company to market risky loans at the height of the housing bubble.

The Sandlers long viewed themselves — and were viewed by many others — as the mortgage industry's model citizens. Now they too have been swept into the maelstrom surrounding who is to blame for the housing bust and the growing number of home foreclosures.

Once invited by Congress to testify about good lending practices, the Sandlers were recently parodied on "Saturday Night Live" as greedy bankers who handily sold their bank — and pocketed $2.3 billion in shares and cash — in 2006 before many of their loans began to sour.

Last month, the United States attorney's office in San Francisco announced dual inquiries into whether World Savings engaged in predatory lending practices or misled investors about its financial well-being. And the bank has been sued by numerous borrowers who claim they were misled into taking out mortgages they could not afford.

At the center of the controversy is an exotic but popular mortgage the Sandlers pioneered that helped generate billions of dollars of revenue at their bank.

Known as an option ARM — and named "Pick-A-Pay" by World Savings — it is now seen by an array of housing analysts and regulators as the Typhoid Mary of the mortgage industry.

Pick-A-Pay allowed homeowners to make monthly mortgage payments that were so small they did not cover their interest charges. That meant the total principal owed would actually grow over time, not shrink as is normally the case.

Now held by an estimated two million homeowners, the option adjustable rate mortgage will be at the forefront of a further wave of homeowner distress that could greatly delay or even derail an economic recovery, mortgage industry analysts say.

The Wachovia Corporation, which bought the Sandlers' bank two years ago, was so battered by the souring portfolio of World Savings that it began writing off losses now projected at tens of billions of dollars and eventually stopped offering option ARMs.

Through it all, the Sandlers have maintained they did nothing wrong beyond misjudging the real estate bubble.

"I didn't mislead anybody, and to the best of my knowledge, our company didn't, though there may have been an isolated case here and there," Mr. Sandler said. "If home prices hadn't declined by 50 percent, nobody would be raising these questions."

Mr. Sandler also finds it incredible that borrowers feel victimized by Pick-A-Pay. "All of a sudden their home is worth half of what it was, and they say they didn't know."

Yet the Sandlers embraced practices like the use of independent brokers who used questionable methods to reel in borrowers. These and other practices, critics contend, undermined the conservative lending practices that the Sandlers built their reputations upon.

"This product is the most destructive financial weapon ever deployed against the American middle class," said William J. Purdy III, a housing lawyer in California who is representing elderly World Savings customers struggling to repay their loans. "People who have this loan are now trapped, and they can't get another loan."

The Birth of Pick-A-Pay

Marion Sandler, now 78, was a Wall Street analyst in the early 1960s when she and her husband decided to buy a bank that took only savings deposits and made mortgage loans — a thrift, or savings and loan, in banking shorthand — and run it themselves.

Mr. Sandler, now 77, was a lawyer in Manhattan who grew up poor on the Lower East Side, the son of a compulsive gambler whose earnings were consumed by loan sharks.

The Sandlers searched for a thrift in the sizzling California market and paid $3.8 million in 1963 for an Oakland enterprise called Golden West Savings and Loan Association, which later became the parent company of World Savings. It had a main office and one branch.

When Reagan era deregulation arrived, the Sandlers and two other competitors were able to market option ARMs for the first time in 1981. Before that, lawmakers balked at the loan because of its potential peril to borrowers.

World Savings initially attracted borrowers whose incomes fluctuated, like professionals with big year-end bonuses. In the recent housing boom, when World Savings started calling the loan Pick-A-Pay, they began marketing it to a much broader audience, including people with financial troubles, like deeply indebted blue-collar workers.

As the entire thrift industry soared after deregulation, the Sandlers' business also took off. They avoided financial problems by doing things like scrutinizing borrowers' incomes to make sure loans were manageable and performing astute appraisals so the size of a mortgage was in line with the value of a home.

"Our protection was our total underwriting of the loan," Mr. Sandler said. "From scratch."

When many of the Sandlers' competitors in the thrift industry later began collapsing under the weight of bad loans and investments, Congress and the media invited the couple to speak about the proper way to do business.

"The deregulatory situation attracted bums, charlatans, crooks, phonies, con men," Mr. Sandler told an ABC News program in 1990.

The Sandlers also held onto World Savings' loans rather than selling them off to Wall Street to be repackaged as securities. They say this made them more alert to risky borrowers than were lenders who sold off their loans.

When foreclosures occurred, World Savings executives would drive to the house to see if they had made mistakes appraising the property or underwriting the loan. "We called these the van tours," Mr. Sandler said. "And we would say, 'O.K., have we done anything wrong here?' "

More Philanthropic Work

As the Sandlers' wealth increased, so did their philanthropy. Over the years, they financed scientific research and groups like Human Rights Watch and the American Civil Liberties Union. More recently they founded and financed ProPublica, a nonprofit investigative journalism enterprise that has collaborated with The New York Times on coverage and a news archive. Its 14-member advisory board includes two top New York Times Company editors.

The Sandlers' giving intersected most directly with their business interests in 2002 when they helped create an advocacy group for low-income borrowers called the Center for Responsible Lending.

The center was the successor to a smaller organization in North Carolina, whose director, Martin Eakes, had helped the elderly and minorities avoid predatory banking practices.

“I said, ‘Isn’t that incredible what he is doing?’ ” Mr. Sandler recalled. “I said to Martin, ‘What would it take to do what you do on a national scale?’ ”

Mr. Eakes, who became the center’s executive director, had also just helped secure a new mortgage lending law in North Carolina that prohibited, among other things, the use of prepayment penalties.

“I hated prepayment penalties,” Mr. Eakes recalled, noting that such charges make it hard for cash-poor borrowers to refinance a loan for one with more manageable terms.

While Mr. Sandler supported the center’s antipredatory goals, he disagreed with Mr. Eakes’s position on prepayment penalties and sought to change his mind.

Mr. Sandler acknowledges that some lenders used the penalties to lock borrowers into “absolutely awful” loans. But he said his bank used the penalties to fend off unethical brokers who enticed borrowers with low-interest-rate loans that often had hidden fees.

“You have to understand how independent brokers work,” Mr. Sandler says. “They are the whores of the world.”

Despite that distaste, World Savings made extensive use of brokers. By 2006, they were generating some 60 percent of its loan business, he acknowledged. He said he was compelled to do so because of brokers were a dominant force in the mortgage industry.

As a check on the representations that brokers made to borrowers, World Savings sought to telephone applicants to ensure that they understood the terms of their loan. These calls reached only about half of the borrowers, however, according to a former World Savings executive. Mr. Sandler did not dispute that point.

Customer complaints that an unethical broker had misrepresented the terms of World Savings loans is at the heart of a lawsuit filed against the bank and others in Alameda County, Calif. The broker was sentenced to a year in prison for misleading at least 90 World Savings borrowers.

Mr. Sandler points out that the company was itself a victim of this broker, that it cooperated fully with authorities, and that it was not charged with any wrongdoing.

Others have also raised questions about how carefully World Savings disclosed lending terms to its borrowers.

In August, a federal judge in South Carolina ruled that World Savings had violated the federal Truth in Lending Act by telling borrowers that choosing to make minimum monthly payments on Pick-A-Pay mortgages might cause their principal to grow — when in fact it certainly would occur.

Wachovia, which is defending the case, has appealed the ruling. Mr. Sandler said he was not familiar with this lawsuit, but generally, he says, “Wachovia’s legal defense is deficient.”

A Speedy Merger

By 2005, World Savings lending had started to slow, after more than quadrupling since 1998. The next year, Wachovia bought the bank in a hastily arranged deal. The Sandlers say they sold their firm at the top of the market because they were growing older and wanted to devote themselves to philanthropy.

Some current and former Wachovia officials say that the merger was agreed to in days and that it was impossible to conduct a thorough vetting of World Savings' loans. Others say the portfolio was adequately scrutinized.

"Herb and his wife had run a tight ship," said Robert Brown, a Wachovia board member. "There was not a huge concern about it because they had not had any delinquencies and foreclosures."

Others were less sanguine. The creditworthiness of World Savings borrowers edged down from 2004 to 2006, according to Wachovia's data. Over all, Pick-A-Pay borrowers had credit scores well below the industry average for traditional loans.

"I don't think anyone thought a Pick-A-Pay product was a customer friendly product," says a former Wachovia executive who requested anonymity to preserve professional relationships. "It is easy to mislead them."

World Savings lending volume dipped again in 2006 shortly after the sale to Wachovia was initiated, according to the company's federal filings.

This prompted World Savings to attract more borrowers by taking a step that some regulators were starting to frown upon, and which the company had been resisting for years: it allowed borrowers to make monthly payments based on an annual interest rate of just 1.5 percent. While World Savings continued to scrutinize borrowers' ability to manage increased payments, the move to rock-bottom rates lured customers whose financial reliability was harder to verify.

Russell W. Kettell, a former chief financial officer of World Savings, says the merger created "pressure" for "a pretty good-sized increase in loan volume."

Asked if Wachovia ordered World Savings to drop its rate, Mr. Kettell said, "No, but they wanted volume and wanted growth."

A swift increase in option ARM lending had prompted federal regulators to weigh tougher controls on lending standards in 2005. Of the $238 billion in option ARM loans made nationally in 2005, World Savings issued about $52 billion, or more than one-fifth of the total.

Susan Schmidt Bies, a governor of the Federal Reserve System until last year, said the surge in volume in ARM lending caught regulators by surprise, and that she regrets not acting more quickly to protect borrowers because she believes that they could not understand the risky nature of option ARMs.

“When you get into people whose mortgage payments are taking half of their cash flow, they are in over their heads, and these loans should not have been sold to this customer base,” she said. “This makes me sick when I see this happening.”

In March 2006, two months before the Wachovia deal, Mr. Sandler wrote regulators and objected to several aspects of the new rules, including the regulator’s conclusion that option ARMS “were untested in a stress environment.”

He argued in the letter that World Savings had few loan losses in the recession of the early 1990s. Then again, the current financial crisis is far more severe than what occurred then — far more severe than anything the country has faced since the Great Depression.

By the third quarter of this year, Wachovia was projecting $26.1 billion of losses on a World Savings loan portfolio worth a total of about $124 billion. About 6.2 percent of the Pick-A-Pay loans were more than 90 days late, it said, compared with an industry average of 8 percent on option ARMs and 1 percent on Wachovia’s traditional loans.

Wells Fargo, which is now buying Wachovia, is more pessimistic: it expects losses of $36 billion on the loans unless efforts to stem foreclosures help rescue part of the portfolio. The losses caused analysts and others to reassess the Sandlers’ legacy.

After the “Saturday Night Live” skit, Paul Steiger, the former executive editor of The Wall Street Journal and the editor in chief of ProPublica, was among those who wrote to the show’s producer, Lorne Michaels, saying the Sandlers had been unfairly vilified. Mr. Michaels apologized for the skit (which suggested that the Sandlers “should be shot”) and removed it from NBC’s Web site.

Mr. Sandler says Wachovia did not work hard enough to help struggling borrowers, and that his loans became scapegoats for other problems at Wachovia. He remains confident that losses on its loans will not reach Wells Fargo’s projections.

He says World Savings was hit especially hard because it had made so many loans in volatile markets like inland California, but he disputes homeowner assertions that his option ARMs are at fault.

“We have not been able to identify one delinquency, much less a foreclosure, that is due to the product,” Mr. Sandler said, adding that “if home prices had not dropped, you wouldn’t see” a single article.

Over all, analysts expect the option ARM fallout to be brutal. Fitch Ratings, a leading credit rating agency, recently reported that payments on nearly half of the $200 billion worth of option ARMs it tracks will jump 63 percent in the next two years — causing mortgage delinquencies to rise sharply.

Mr. Sandler says that his loans are not in the pool that will become distressed in the next few years; he says they reset at a later date. He adds that were he not sure that the market would recover he would have sold his Wachovia stock at the time of the takeover. His charity has sold off much of its Wachovia stock, but he said he and his wife retain a substantial portion of their personal holdings.

Still, the Sandlers have their detractors.

“As the largest and most respected regulated institution providing option ARMs, I hold the Sandlers responsible because a large percentage of home borrowers — but not all — should have been advised that it was in their best interest to have a fixed-rate mortgage,” said Robert Gnaizda, general counsel for the Greenlining Institute, a homeowner advocacy group. “I believe that financial institutions have a quasi-fiduciary responsibility not to mislead the borrower.”

Mr. Sandler insists that World Savings prided itself on ethical conduct and that untoward behavior was never tolerated. “We were also a family, and you expected people to live their personal and business lives in a particular way,” he said.

Renee Feltz contributed reporting and research.

This article has been revised to reflect the following correction:

Correction: January 6, 2009

A headline on Dec. 25 with an article about Herbert and Marion Sandler, bankers and philanthropists whose World Savings Bank originated a type of adjustable-rate mortgage called Pick-a-Pay that has led to many foreclosures as the real estate market and the economy collapsed, described incorrectly the consequences to the Sandlers of the criminal and legal investigations of the practices of the bank, which they sold to Wachovia in 2006. As the article noted, the Sandlers were once trusted mortgage pioneers and now face scrutiny, but they are not “pariahs.”

This article has been revised to reflect the following correction:

Correction: January 16, 2009

An article on Dec. 25 about Herbert and Marion Sandler, bankers and philanthropists whose World Savings Bank pioneered a type of adjustable-rate mortgage called the Option ARM, referred imprecisely to their discussions on prepayment penalties with Martin Eakes, the chief executive officer of the Center for Responsible Lending, which the Sandlers helped found in 2002. During the housing boom, they were among those who persuaded Mr. Eakes of the acceptability of some proposed state regulations that would strictly limit, though not ban, prepayment penalties on the small fraction of prime mortgages that had them, including those from World Savings. Mr. Eakes and the Center for Responsible Lending have continued to oppose prepayment penalties generally, on both prime and sub-prime mortgages; Mr. Eakes did not “drop his opposition.”

This article has been revised to reflect the following correction:

Correction: June 11, 2009

An article on Dec. 25, 2008, about Herbert and Marion Sandler, whose World Savings Bank marketed adjustable-rate mortgages called option ARMs, referred imprecisely to a decision after the bank's sale to Wachovia was initiated in 2006 to get more customers for such mortgages by lowering to 1 percent the interest rate borrowers would have to pay. World Savings reduced the rate then from 2.85 percent to 1.5 percent, but it was Wachovia that lowered the rate to 1 percent, in 2007, according to data the Sandlers provided after the article was published.

The article also gave insufficient context for comments by Susan Schmidt Bies, a former Federal Reserve System governor, regretting that federal regulators had not imposed tougher controls on lending standards for option ARMs before the collapse in the real estate market that led to bank losses, foreclosures and recession. She was discussing option ARM lenders generally, not World Savings specifically.

These corrections were delayed by research and consideration at The Times.