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Last One Standing

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Babette Heimbuch joined FirstFed Financial Corp. more than 25 years ago, just about the time the thrift made its first option adjustable-rate mortgage loan.

She was there as FirstFed grew into one of the nation's largest so-called option ARM lenders. And she is there today as chief executive as FirstFed is the last one standing among all the big lenders of those risky loans.

Since souring option ARMs have taken down a number of big lenders, the big question looms: Will FirstFed, a savings and loan founded in Santa Monica on the eve of the Great Depression, be next?

"We'd be fools not to be nervous," said Heimbuch, a thin-framed woman with a shock of orange hair. "But all we can do now is work really hard to fix the problems that we have."

With 38 branches across Los Angeles and assets of $6.8 billion, FirstFed is L.A.'s fifth largest depository institution. Much of its growth, however, has come on the back of the variable-rate loans that have been defaulting in large numbers in the past two years.

FirstFed, the parent of First Federal Bank of California, has endured nearly $300 million in losses in just the past two quarters while its loan-loss provision has ballooned to more than $300 million. Nonperforming assets now stand in excess of 8 percent of total assets – even half that amount would be considered high.

In January, regulators placed the thrift under a cease-and-desist order over concerns that its capital supply was rapidly depleting. Even its auditor expressed doubt about its ability to survive.

Yet the institution is still around, and executives, who admit that the work can be draining, said they expect it to stay that way.

"The risk in this portfolio was not Armageddon," said James Giraldin, FirstFed's chief operating officer. "It was pain and suffering, but not Armageddon."

The company has already taken difficult and sometimes drastic steps to stay afloat.

Management instituted a massive – and, to date, successful – loan modification program beginning in 2007, well before most other lenders saw the need. The company halted its lending and reduced staff levels by nearly one-quarter through layoffs and attrition. Top executives took a 10 percent pay cut.

The company also up and moved from its longtime Santa Monica headquarters to a decidedly less expensive building a stone's throw from the Loyola Marymount University campus.

Option ARMs played a major role in precipitating many of the largest casualties of the housing bust – think IndyMac Bank, Downey Savings & Loan, Washington Mutual, BankUnited, Countrywide, Wachovia – and FirstFed executives hope their efforts can help them become the one option ARM lender to avoid that fate.

"We're the last option ARM lender out there," Heimbuch said. "Not to say that we're not struggling and we don't have to raise capital, but we feel like we're getting our arms around the risk."

Community leader

FirstFed opened its flagship branch in 1929 in downtown Santa Monica and quickly became ensconced in the local community.

Bob Holbrook, who was born in the beachside community 67 years ago and has served on the Santa Monica City Council for nearly two decades, said he remembers when he was a child his parents would send him on his bike to the local FirstFed branch with a check for the monthly loan payment.

As an adult, Holbrook went to FirstFed for a home equity line of credit. Many residents, then and now, have looked to the institution for loans, he said.

"(FirstFed) is just synonymous with Santa Monica," Holbrook said. "It's just so tragic that it's fallen on such hard times. I hope they can persevere this economic storm."

FirstFed had been making option ARM loans without incident for more than 20 years. The loans held up well largely because option ARMs tended to be given to borrowers with good credit and proof of income.

But everything changed in the early 2000s, Heimbuch said, when Wall Street firms began securitizing the loans in large numbers. The AAA-rated bonds were seen as low risk and became increasingly popular as an investment. In the process, competition grew intense, leading lenders to drop their underwriting standards to dangerous levels.

"When Wall Street came in and had really low pay rates with no documentation, that just bastardized the loan and ruined it," she said.

Giraldin remembers the day he realized that Wall Street's influence would prove disastrous. In the fourth quarter of 2005, he learned that one of the top local competitors was a subsidiary of Bear Stearns.

At that moment, he said, he knew that securitization was truly taking hold of the industry. Turning to Heimbuch, he said, "This is over."

A growing number of borrowers began opting for the minimum monthly payment, which sometimes did not even cover the interest rate. Known as "negative amortization" loans, they often prove problematic after a few years when borrowers are required to pay full interest plus principal, at which point the monthly payments can increase considerably.

FirstFed readily admits it made the mistake of dropping its own standards in a misguided attempt to remain competitive. It did that mostly in 2005, a year in which the thrift originated $4.4 billion in single-family loans – primarily option ARMs and most without full verification of income or assets.

But the thrift was also one of the first to pull back. By late 2005 and into 2006, managers made the decision to stop underwriting the riskiest loans and begin requiring proof of income. Within two weeks, their business dropped in half.

"We really cut back," Heimbuch said. "We took a lot of grief for that. People were saying, 'Why aren't you lending? Everyone else is lending. What's the matter with you?' "

In 2007, FirstFed originated just $300 million in single-family loans for its own portfolio – a move management said has helped it survive while its competitors could not.

Still, Giraldin pointed out, just a year of unwise lending has pushed the company to the brink of failure.

"Most of our pain and suffering comes from that '05 production," he said.

Since then, shareholder value has been all but wiped out. Its stock, which traded at more than $69 a share in 2007, closed June 25 at 35 cents.

The stock has long been a target of short sellers, particularly after the failure of IndyMac, when many began speculating that FirstFed would be closed soon thereafter.

Greg Weston, a real estate litigator who shorted the stock for months as the price dropped, wrote an online article detailing the reasons investors should do so. Weston, founder of the Weston Firm in San Diego, recently

stopped selling the stock short and closed out the position. He doesn't think the company has a bright future, but since the stock is less than $1, most of the play is gone.

"It's pretty much dead as an investment," he said.

In late 2007, with a $4.4 billion portfolio of option ARM loans set to recast, FirstFed began working aggressively to modify its at-risk loans. The company created a loan modification division and staffed it with employees from other parts of the company, such as lending.

But rather than restrict the program to delinquent loans, FirstFed set out to contact every single borrower whose loan would recast with higher payments, giving them all an opportunity to address problems before they even arose.

'Extraordinary job'

Rick McGill, a banking veteran who served as president of Downey for nine months before it was seized by regulators and sold to U.S. Bancorp, lauded FirstFed for being proactive in addressing its problems.

"Management has done an extraordinary job of trying to do the right thing," he said. "I think they've done a terrific job to date in terms of aggressively modifying home loans."

In the past year and a half, FirstFed has modified some 2,000 loans, which constitute $2.8 billion of its option ARM portfolio. Giraldin, who has spent time recently in the company's call center and personally modified loans for borrowers, said a new effort currently under way could modify all but $400 million of the remaining loans.

The program is showing early signs of success: More than 80 percent of the modified loans are current. Management attributes that to the fact that its program, unlike many others, does not have specific debt-to-income ratio guidelines and FirstFed does not wait until a borrower has defaulted before modifying.

At the same time, FirstFed's 30-day delinquencies have declined for five consecutive months.

"Five months," said Giraldin, excitedly. "It is a trend line."

Meanwhile, the company has been looking to cut costs anywhere it can. That has included selling branch real estate, laying off 10 percent of staff and relocating from Santa Monica.

The new office, across the street from the Playa Vista development, is big and bare, lacking the lived-in feel of a typical 80-year-old company's headquarters.

FirstFed executives admit that it can be difficult to come into work some days with the stress of leading a company through such a turbulent time.

"There is no doubt it can be tremendously draining at times," Giraldin said.

Management has to walk a fine line, balancing the long-term interests of the institution with the needs of customers, the wishes of employees and the demands of regulators.

At the behest of regulators, FirstFed recently halted its lending and began courting private equity firms to raise investment capital.

Capital – any lender's crucial internal financial resource – is one of the primary concerns of regulators and was a key point in the cease-and-desist order. Banks and thrifts must have a ratio of at least 10 percent to be considered "well-capitalized" by regulators.

At the end of the first quarter, FirstFed's risk-based capital ratio was 10.36 percent. Just over a year ago, the ratio was in excess of 21 percent.

Raising capital has been a difficult task of late, but the markets are beginning to thaw, experts said.

“It’s still pretty tough but capital is coming back into the banks,” according to bank consultant Bert Ely. Still, he said, raising capital will not necessarily save the institution, but some are more hopeful.

McGill, the former Downey chief, said with each passing day FirstFed’s prospects for survival seem to grow.

“They’ve hung in there in certainly the most difficult market I’ve seen, and I’ve been in banking 40 years,” he said. “They’re still here. That kind of speaks for itself.”

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