

**THE CREDIT CRISIS AND SUBPRIME LITIGATION: HOW FRAUD
WITHOUT MOTIVE ‘MAKES LITTLE ECONOMIC SENSE’***

ARTICLE

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I. INTRODUCTION

ON SEPTEMBER 29, 2008, THE DOW JONES INDUSTRIAL AVERAGE DROPPED 777 points, the greatest single day point drop ever.¹ The precipitous drop illustrated the volatile state of the market during the recent

* *Luminent Mortg. Capital, Inc. v. Merrill Lynch & Co.*, 652 F. Supp. 2d 576 (E.D. Pa. Aug.20, 2009).

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¹ See Eric Martin, *U.S. Stocks Drop as Recession Concern Outweighs Bailout Passage*, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeulcKoruEHs> (last visited Aug. 4, 2010). (Reporting losses sustained in U.S. market).

Credit Crisis.² The Credit Crisis³ began with a complex chain of events.⁴ Falling housing prices and subprime mortgages are generally considered the starting blocks of the Crisis.⁵ Subprime mortgage origination accounted for \$1.2 trillion in 2005 and 2006.⁶ Ten percent of subprime mortgages, however, were more than sixty days delinquent or in foreclosure by the end of 2006, well above normal levels.⁷ These deteriorating loans sent shockwaves through the financial system because the loans were held by several financial market participants.⁸ The credit market subsequently halted as lenders became wary of borrower credit.⁹

The global economy suffered and continues to suffer enormous losses from the Credit Crisis.¹⁰ With financial losses came lawsuits.¹¹ The majority of subprime plaintiffs follow comparable narratives to their claims.¹² Plaintiffs blame their economic losses during the Credit Crisis on banks originating faulty subprime loans for distribution.¹³ According to the originate-to-distribute narrative,

² See *id.* (stating market conditions).

³ See Catherine Rampell, 'Great Recession': A Brief Etymology, NYTimes.com, Mar. 11, 2009, available at <http://economix.blogs.nytimes.com/2009/03/11/great-recession-a-brief-etymology/> (discussing naming of the "Credit Crisis"). This paper will refer to the 2007-2008 financial disruption as the "Credit Crisis."

⁴ See JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSE, PROLONGED, AND WORSENE THE FINANCIAL CRISIS 15 (Hoover Institution Press 2009) (noting importance of August 9th, 2007).

⁵ See *id.* at 1 (describing falling housing prices role in Credit Crisis).

⁶ See Gary Gorton, *The Panic of 2007* at 3 (Yale ICF, Working Paper No. 08-24, 2008), available at <http://ssrn.com/abstract=1255362> (conveying economic importance of subprime mortgage origination).

⁷ See TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, IOSCO, REPORT ON THE SUBPRIME CRISIS 4 (May 2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf> (reporting on subprime mortgage delinquencies).

⁸ See Gorton, *supra* note 6, at 34 ("If this was the end of the story, it is not clear whether there would have been a systemic problem when the house price bubble burst.").

⁹ See TAYLOR, *supra* note 4, at 16 (describing credit freeze).

¹⁰ See generally, CHARLES R. MORRIS, THE TWO TRILLION DOLLAR MELTDOWN 64 (2008) (detailing losses suffered in global economies).

¹¹ See Jennifer Bethel, Allen Farrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* 2-3, (Harvard John M. Olin Discussion Paper Series, No. 612, 2008), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf (stating increase in securities fraud cases following crisis).

¹² See, e.g., Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 658 F. Supp. 2d 299, 303 (D.Mass. 2009) (discussing plaintiffs' allegations); *Atlas*, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming inflated stock price on misrepresentations regarding companies' core business); New York State Teachers' Retirement Systems v. Fremont General Corp., 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (arguing poor lending standards contributed to common stock devaluation).

¹³ See Bethel, et. al., *supra* note 11, at 33-34 (describing claims by MBS purchasers).

lenders originated poor quality loans and passed the risk onto investors through securitization.¹⁴ The risks associated with the loans were allegedly not disclosed to investors.¹⁵ Therefore, according to this narrative, originators committed securities fraud to their investors by not disclosing.¹⁶

This article argues that the majority of securities fraud claims arising out of the Credit Crisis are ill founded. Section II presents background information on the subprime mortgage securitization process. Section III discusses the relevant securities law. Section IV analyzes the validity of securities fraud claims in light of what we know about the causes of the Credit Crisis. Finally, Section V concludes the paper with final remarks on the Credit Crisis and securities fraud claims connected with the Credit Crisis.

II. SECURITIZATION: FINANCIAL INNOVATION OR FINANCIAL FRANKENSTEIN?

A. *The Subprime Mortgage Market and Housing Prices*

From 2000-2007, the subprime mortgage market grew 800 percent, whereas overall mortgages merely doubled.¹⁷ Lenders categorize borrowers by the risk associated with their ability for loan repayment.¹⁸ Borrowers are defined as “prime” and “nonprime.”¹⁹ Prime borrowers are the traditional borrower and exhibit great credit characteristics.²⁰ A standard prime mortgage is set at a fixed-interest rate for thirty years.²¹ The borrower has the right to default or prepay the mortgage.²²

¹⁴ See Frederic S. Mishkin, Governor, Bd. Of Governors Federal Reserve System, Speech at the Wharton Financial Institutions Center and Oliver Wyman Institute’s Annual Financial Risk Roundtable: How Should We Respond to Asset Price Bubbles? (May 15, 2008), <http://www.federalreserve.gov/newsevents/speech/mishkin20080515a.htm> (discussing misaligned incentives of originators and investors in originate-to-distribute banking) (last visited Aug. 11, 2010).

¹⁵ *Nomura Asset Acceptance Corp.*, 658 F. Supp. 2d 299, 303 (stating that lender misrepresented loan quality).

¹⁶ See *id.* (providing plaintiffs’ argument that lender committed securities fraud).

¹⁷ See Gorton, *supra* note 6, at 8 (reporting growth of subprime market).

¹⁸ See Sumit Agarwal & Calvin T. Ho, The Federal Reserve Bank of Chicago, *Comparing the Prime and Subprime Mortgage Markets*, Chicago Fed Letter No. 241, August 2007, available at http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2007/cflaugust2007_241.pdf (stating varying risk characteristics in borrowers).

¹⁹ See *id.* (discussing differences between prime and nonprime borrowers).

²⁰ See *id.*

²¹ See Gorton, *supra* note 6, at 13 (describing standard prime mortgage operation).

²² See *id.* (“The usual way of thinking of mortgage design and pricing is to recognize the embedded optionality in these mortgages: the borrower has the right to prepay the mortgage (a call option to refinance) and the right to default (a put option).”).

Nonprime borrowers are broken down into Alt-A and subprime.²³ Alt-A borrowers generally have good credit scores and are considered between subprime and prime borrowers in terms of risk.²⁴ For conveniences purposes I will refer to Alt-A and subprime borrows collectively as subprime unless otherwise indicated. The *Interagency Expanded Guidance for Subprime Lending* defines a subprime borrower as a person who exhibits one or more of the following credit risk characteristics:

two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge-off in the last 24 months; bankruptcy in the last five years; relatively high probability of default as evidenced by, for example a credit bureau risk score (FICO) of 660 or below; debt service-to-income ratio of 50 percent or greater; or, otherwise limited ability to cover family living expenses after deducting total debt-service requirements from monthly income.²⁵

Subprime borrowers are therefore riskier borrowers than prime borrowers because there is a history of poor repayment ability.²⁶

Subprime lending is based upon the assumption that potential home equity is the greatest form of wealth for a low-income household.²⁷ “If borrowers can lend to these households for a short time period, two or three years, at a high, but affordable interest rate, and equity is built up in their homes, then the mortgage can be refinanced with a lower loan-to-value [(“LTV”)] ratio, reflecting the embedded price appreciation.”²⁸ The LTV ratio is “[t]he balance of a mortgage loan expressed as a percentage of the property’s appraised value. For example, a \$200,000 loan on a home appraised at \$250,000 has an LTV of 80% (\$200,000 / \$250,000).”²⁹ Subprime mortgages start with an initial fixed-rate ending with the “reset date,” (usually after 2 or 3 years) whereupon the borrower is incentivized

²³ See Sumit Agarwal & Calvin T. Ho, *supra* note 18 (explaining borrower classes).

²⁴ See *id.* (defining Alt-A borrowers).

²⁵ Press Release, Federal Deposit Insurance Corporation, Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), <http://www.fdic.gov/news/news/press/2001/pro901a.html> (last visited August, 5, 2010). “Sub-prime lending involves originating and purchasing loans for borrowers considered high-risk by traditional credit and underwriting standards.” In re New Century, 588 F.Supp.2d 1206, 1209 (C.D. Cal. 2008).

²⁶ See Federal Deposit *supra* note 30. (detailing characteristics of subprime borrowers). See also Gorton, *supra* note 6, at n.17. Commenting on how a prime borrower may be defined as subprime because of little documentation.

²⁷ See Gorton, *supra* note 6, at 7 (describing basic assumption used for lending to subprime borrowers).

²⁸ *Id.*

²⁹ See Credit Suisse, *CSFB’s Starter Kit for Non-Agency Residential Mortgage-Backed Securities*, Oct. 20, 2005, at 90, available at <http://www.scribd.com/doc/19605788/Credit-Suisse-CFBSs-Starter-Kit-for-NonAgency-Residential-MortgageBacked-Securities> (defining loan-to-value ratios).

to refinance the mortgage otherwise triggering a much higher rate.³⁰ The overwhelming majority of subprime mortgages include prepayment penalties to discourage prepayment.³¹ The combination of the hybrid adjusted-rate mortgage (“ARM”) and prepayment penalties deter the borrower from refinancing before or after the reset date allowing the lender to decide whether to refinance or take the recovery value left after foreclosure.³² Subprime mortgages work by “forcing” the borrower to refinance after two or three years.³³ “The lender is essentially long [on] the house, exposing the lender to house prices more sensitively than conventional mortgages.”³⁴ Moreover, “[t]he key security design feature of subprime mortgages was the ability of borrowers to finance and refinance their homes based on the capital gains due to house price appreciation over short horizons and then turning this into collateral for a new mortgage (or extracting the equity for consumption).”³⁵ Without house appreciation, a great number of subprime mortgages default.³⁶ Subprime mortgage loans are more sensitive to housing prices than prime mortgage loans because of the forced refinancing.³⁷ Thus, the lender and borrower are attempting to benefit from price appreciation in the home over a short time horizon.³⁸

30 See Gorton, *supra* note 6, at 12 (explaining “reset date” feature of subprime mortgages). Mortgage loans are of the “2/28” and “3/27” variety. See *id.* Most loans have a 30-year amortization so the 2 and 3 represent the yearly amount the rate is fixed. See *id.*

31 See Gorton, *supra* note 6, at 13 (detailing importance of prepayment penalties).

32 See *id.* at 16 (analyzing rationale behind forcing borrower to refinance). Using a sample pool of securitized subprime mortgages originated by New Century Financial, it is noted by Adam Ashcraft and Til Schuermann that the majority of subprime loans in the pool are for refinancing and not purchasing a home. See ADAM B. ASHCRAFT & TIL SCHUERMANN, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT, FEDERAL RESERVE BANK OF NEW YORK STAFF, REPORT NO. 318, at 21-23 (2008), available at http://ssrn.com/abstract_id=1071189.

33 See Gorton, *supra* note 6, at 12 (noting how subprime mortgages “force” borrowers to refinance). Subprime mortgages are hybrid mortgages with an initial two or three year fixed-rate followed by a generally higher adjustable-rate. See *id.*

34 *Id.* at 17 (explaining rationale for subprime mortgage origination).

35 *Id.* at 3.

36 See ASHCRAFT, *supra* note 32, at 21-23 (portraying problems subprime mortgages have in both stagnate and declining housing markets). “[A] national price decline of 10 percent could put half of all subprime borrowers underwater.” *Id.* at 22.

37 See Gorton, *supra* note 6, at 4 (remarking on added sensitivity of housing prices to securitization of subprime mortgage loans).

38 See *Id.* at 12 (examining relationship of house price appreciation to subprime mortgage loan).

B. *The Securitization Process*

Securitization converts mortgage loans into mortgage-backed securities (“MBS”).³⁹ Securitization is important because it can transform previously untradeable assets into tradable asset-backed securities (“ABS”).⁴⁰ MBS are a type of ABS whereby mortgage loans are pooled and sold as a debt obligation for the claim to the future payments on the mortgage loans by the home owner.⁴¹

A typical mortgage loan to MBS conversion and transaction consists of several steps.⁴² A mortgage lender, the originator, lends money to many home owners to finance the purchase of homes.⁴³ The originator holds the mortgage loans representing a right to future payments on the originators’ balance sheet; these rights are called “receivables.”⁴⁴ The originator determines the average rate of default for the loans and securitizes them for sale to a third party investor.⁴⁵ The originator contributes the receivables related to the loan to a trust, new special purpose corporation, or other legally separate entity, a/k/a a Special Purpose Entity (“SPE”).⁴⁶ By transferring the loan to a SPE, investors are assured that if the originator files for bankruptcy, third-party creditors have no claim against

³⁹ See Richard J. Rosen, The Federal Reserve Bank of Chicago, *The role of securitization in mortgage lending*, Chicago Fed Letter No. 244, November 2007, available at www.bus.ucf.edu/ssmith/MtgSec11.07.pdf (discussing subprime securitization). According to Frank J. Fabozzi & Vinod Kothari, *Securitization: The Tool of Financial Transformation* 3, (Yale ICF Working Paper No. 0707, 2007), available at <http://ssrn.com/abstract=997079>:

Today securitization is understood to mean a process by which an entity pools together its interest in identifiable future cash flows, transfers the claims on those future cash flows to another entity that is specifically created for the sole purpose of holding those financial claims, and then utilizes those future cash flows to pay off investors over time, either with or without credit support from a source other than the cash flows.

⁴⁰ See Ronel Elul, *The Economics of Asset Securitization*, 2005 BUS. REV. Q3, 16 (2005) (detailing asset securitization process).

⁴¹ See U.S. Securities & Exchange Commission, *Mortgage-Backed Securities*, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Aug. 5, 2010) (providing definition for mortgage-backed securities).

⁴² See SCHWARCZ, *infra* note 64, at 6-8 (walking through typical mortgage loan to MBS conversion and transaction). For a graphical representation of the securitization process and the players involved, see Christopher L. Peterson, *Subprime Mortgage Market Turmoil: Examining the Role of Securitization – A hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment* 4, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4f40e1b9-ec5b-4752-ba8f-0c14afc44884 (last visited Aug. 11, 2010) (providing complex graphical representation of securitization process).

⁴³ See Elul, *supra* note 40 (detailing mortgage loan origination).

⁴⁴ See SCHWARCZ, *infra* note 69, at 135 (defining receivables).

⁴⁵ See *id.* (explaining importance of risk assessment by originator when securitizing loan).

⁴⁶ See *id.* (describing separation of assets from firm).

the loans.⁴⁷ The SPE pools and holds onto the mortgages and issues securities or bonds to investors.⁴⁸

MBS are tranced by the SPE so that investors can further assess the risk they wish to purchase.⁴⁹ Tranching the mortgages splits the receivables according to the pre-payments and future payments of the mortgages.⁵⁰ A standard mortgage pool is sliced “into a senior (AAA) tranche, mezzanine tranches (AA, A, BBB), [and] subordinated tranches (BB, B, and unrated)” resulting in a typical “senior/sub” tranching structure.⁵¹ A “senior” mortgage tranche becomes the claim for first payment.⁵² The next mortgage tranche is a claim to the next allocation of payment and so on.⁵³ The senior tranche is paid off first followed by the next tranche.⁵⁴ The lower tranche must wait longer than the senior tranche before being paid.⁵⁵ The risk of mortgage default increases the longer the wait.⁵⁶ Therefore, the risk of non-payment increases the lower the tranche.⁵⁷

Generally, MBS are broken into the traditional “six-pack” structure so the senior tranche is protected by six layers of subordination.⁵⁸ Tranching allows the firm to overcollateralize the lower tranches.⁵⁹ Overcollateralization means the debt issued is backed by an amount of debt greater than that issued.⁶⁰ In addition to overcollateralization, mezzanine and subordinate subprime tranches “are tranced to be thick enough to absorb collateral losses to ensure that the senior

⁴⁷ See *id.* (briefly mention why this occurs). The transfer to the SPE generally is a “true sale.” See *id.* A “true sale” is required for bankruptcy purposes. See *id.* (citing 11 U.S.C. §541 (1988)). Additionally, the SPE’s business operations are limited because of the bankruptcy concerns. See *id.* If the originator controls the SPE, the SPE will need one or more independent directors. See *id.* at 136.

⁴⁸ See SCHWARZ, *infra* note 64, at 7 (describing securitization process).

⁴⁹ See Elul, *supra* note 45, at 18 (analyzing mortgage tranching). See also Securities Industry & Financial Markets Association, *The Various Types of CMOs*, <http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=35> (last visited Aug. 5, 2010) (providing basic understanding of collateralized mortgage obligations).

⁵⁰ See Elul, *supra* note 45, at 18 (describing MBS tranching).

⁵¹ Gorton, *supra* note 6, at 23-24 (remarking on distribution of tranches).

⁵² See Elul, *supra* note 45, at 18 (discussing mortgage loan tranching).

⁵³ See *id.*

⁵⁴ See *id.* (explaining payment order following tranching).

⁵⁵ See *id.*

⁵⁶ See *id.* (detailing risk associated with later payment).

⁵⁷ See *id.*

⁵⁸ See Rosen, *supra* note 39 (“For example, some MBSs backed by jumbo loans use a “six-pack” structure, with six layers of subordination.”). “Of the MBSs issued by private firms in 2006, 93% had subordination.” *Id.*

⁵⁹ See ASHCRAFT, *supra* note 32, at 29 (stating relationship of tranching to overcollateralization). Excess spread averaged 2.5% for subprime. See *Id.* at 31.

⁶⁰ See Gorton, *supra* note 6, at 21 (defining overcollateralization).

bonds have a probability of loss sufficiently low to justify a triple-A rating.⁶¹ Overcollateralization and thickness in mezzanine and subordinated tranches allows these tranches to take losses before the senior tranches, thereby enhancing the senior tranche's credit rating.⁶²

Eighty percent of subprime mortgage origination in 2005 and 2006 resulted in securitization.⁶³ There are four financial and economic reasons for securitizing mortgages and other assets.⁶⁴ First, securitization enhances the mortgage loans' credit rating making them easier to sell.⁶⁵ Investors do not have the time or resources to inspect the financial condition of the companies' assets.⁶⁶ Thus, credit ratings help firms assess the level of risk associated with specific securities.⁶⁷ Second, selling the underlying assets removes them from the firm's balance sheet.⁶⁸ Third, investors are more willing to purchase a pool of mortgages as opposed to the individual mortgage because the risk is diversified and hypo-

61 *Id.* at 24.

62 *See* Credit Suisse, *supra* note 29, at 22 (explaining effect of overcollateralization and subordination on credit rating of senior tranche).

63 *See* Gorton, *supra* note 6, at 3 (citing *The 2007 Mortgage Market Statistical Annual*, INSIDE MORTGAGE FINANCE, Joint Economic Committee (October 2007) (relaying securitization statistics).

64 *See generally*, STEVEN L. SCHWARCZ ET. AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS, §1(2004) (examining economic benefits behind securitization). Investors also benefit from the securitization process through a better yield premium compared to treasuries, limited credit risk, and liquidity. *See* Goldman Sachs, *A Mortgage Primer* 20, available at <http://www.scribd.com/doc/19601589/Goldman-Sachs-a-Mortgage-Product-Primer> (Fall 2004).

65 *See* John D. Martin, *A Primer on the Role of Securitization in the Credit Market Crisis of 2007* at 4 (2009), <http://ssrn.com/abstract=1324349> (last visited Aug. 7, 2010) (providing analysis of asset credit enhancement through securitization). A firm may enhance the assets credit rating by purchasing a surety bond, a letter of credit from another financial institution, or credit insurance from monoline insurance companies such as Ambac Financial Group, Inc. and MBIA, Inc. *See id.* Moreover, credit ratings may be enhanced through a government sponsored entity ("GSE"), overcollateralization and tranching. *See* Elul, *supra* note 40, at 16-18. A GSE guarantees the payments of the mortgages to the investor similar to the above mentioned surety bond or insurance method. *See id.* at 17. Overcollateralization occurs when a firm issues a smaller dollar value of securities against a larger pool of mortgages. *See* Martin, *supra* note 65, at 4. Tranching allows the firm to pool its loans together to enhance the credit of some of the tranches while it can hold onto the riskier tranches. *See id.*

66 *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 136 (1994) (detailing importance of credit ratings).

67 *See id.* The greater the investment grade of the securities offered the lower the interest rate the firm must charge; *See also id.* at 137 (arguing that it will reduce the overall cost of funding).

68 *See* Elul, *supra* note 40, at 16 (explaining benefits of securitizing assets). The transfer of the assets to an Special Purpose Entity ("SPE") raises the originator's capital "without increasing the originator's leverage or debt-to-equity ratio on its financial statements." Schwarcz, *supra* note 71, at 143.

thetically easier to calculate when spread.⁶⁹ Finally, mortgages can be split into tranches through securitization.⁷⁰ Tranching allows investors to determine the amount of risk to which they are willing to expose themselves because the investor knows with greater likelihood the risk of default.⁷¹

C. Subprime Mortgage Backed Securities

Subprime securitization is different from ordinary MBS securitization because of the greater credit risk associated with subprime borrowers.⁷² In response to the credit risk posed, the subprime securitization process features many structural innovations.⁷³ First, subprime MBS issuers can use excess spread.⁷⁴ Excess spread is the difference between the interest paid from the subprime mortgages and the interest issued on the MBS.⁷⁵ The excess spread creates overcollateralization to be used in conjunction with the senior/sub structure to further enhance the senior tranche's credit.⁷⁶ The excess spread is used by the issuer to protect investors against losses in the underlying mortgages.⁷⁷ Second, senior bond holders may receive all principal payments before the mezzanine bondholders by shifting the interest payments to the mezzanine holders for lat-

⁶⁹ See Elul, *supra* note 40 (providing benefits to investors of securitized assets). Additionally, investors require less information in a MBS because the mortgages' differences are no longer relevant when pooled. See *id.* at 18.

⁷⁰ See *id.* at 18 (stating mechanics of asset security tranching). "[I]nvestors in the first — senior — tranche receive principal payments from the underlying assets first, those in the second tranche next, and so on. Investors in the last — most junior — tranche receive principal payments from the mortgages in the pool only when the tranches ahead of them in priority have been fully paid." *Id.*

⁷¹ See *id.* (listing benefits of securitization process for investors).

⁷² See Gorton, *supra* note 6, at 19-20 (explaining securitization differences attributable to subprime mortgages).

⁷³ See *id.* at 21 (detailing design features of subprime MBS).

⁷⁴ See ASHCRAFT, *supra* note 32, at 31 (discussing use of excess spread by issuers). See also Rosen, *supra* note 39 Stating that excess spread averaged 2.5% for subprime mortgages in 2006.

⁷⁵ See Gorton, *supra* note 6, at 21 (defining excess spread). Excess spread increases the underlying assets overcollateralization. See *id.* at 24.

⁷⁶ Credit Suisse, *supra* note 29, at 23 (providing relationship of excess spread to OC).

This excess [spread] is initially applied to the reduction of the aggregate principal balance of securities, resulting in a more rapid amortization of the aggregate principal balance of these securities, as compared to the decline in the aggregate mortgage collateral balance. This creates OC and this application of excess interest continues until the OC target is met. Upon funding of the OC, any realized losses on the collateral are covered by the OC and the monthly excess spread prior to the subordinate classes being hit. Remaining excess spread is directed to the residual holder, which may or may not be the issuer.

Id.

⁷⁷ See ASHCRAFT, *supra* note 32, at 31 (stating purpose of excess spread in MBS).

er.⁷⁸ Third, issuers include performance triggers which transfer principal payments immediately from the subordinated bonds to the senior bonds⁷⁹ Performance triggers trigger when there are losses or delinquencies in the underlying mortgages and a specified target level of collateral is not reached.⁸⁰ This process protects the credit enhancement of the senior bonds by ensuring payment on the senior bonds and slowing down or stopping the payments on the subordinated bonds.⁸¹

Additionally, because the majority of the underlying loans are hybrid ARMs and the first couple periods are set at the fixed rate, the issuer may be “exposed to the risk that interest rates increase, so that the cost of funding increases faster than interest payments received on the mortgages.”⁸² Issuers, therefore, enter into interest rate swap agreements with third-parties.⁸³ The issuer agrees to pay the third-party a fixed rate while the third-party pays the issuer an adjustable rate.⁸⁴ Furthermore, issuers provided representations and warranties guaranteeing loan performance.⁸⁵ It is important to also note that the underlying mortgage loans are not homogenous and there is great diversity and complexity across states regarding defaults, housing price appreciation and housing appraisal methods.⁸⁶

D. The Derivatives Market

Credit derivatives are financial instruments “whose payoffs are linked in some way to a change in credit quality of issuer or issuers.”⁸⁷ A type of credit

⁷⁸ See *id.* at 32 (noting shifting interest protection for senior bond holders). See also Gorton, *supra* note 6, at 25 Explaining that after senior bond holders are paid, the next class of bonds is paid sequentially.

⁷⁹ See Gorton, *supra* note 6, at 25 (explaining performance triggers).

⁸⁰ See *id.*

⁸¹ See *id.* at 25. Trigger levels typically change as payments progress. See *id.* “For example, the loss trigger in months 1- 48 might be 3.5 percent, rise to 5.25 percent in months 49-60, 6.75 percent in months 61-72, and stay flat at 7.75 percent thereafter.” *Id.*

⁸² ASHCRAFT, *supra* note 32, at 33.

⁸³ See *id.* (explaining interest rate swap agreements).

⁸⁴ See *id.* Another method of solving the ARM risk problem is making the deal subject to an available funds cap. See Gorton, *supra* note 6, at 25 (stating available funds cap feature of some MBS deals). In an available funds cap deal, “[i]nvestors receive interest as the minimum of Index (e.g., 1-month [London Interbank Offered Rate] LIBOR) plus Margin or the Weighted Average [available funds cap].” *Id.*

⁸⁵ See *Lone Star Fund v. Barclays Bank*, 2008 WL 4449508, *8 (N.D. Tex. 2008) (describing representations and warranties provided by MBS issuer).

⁸⁶ See Gorton, *supra* note 6, at 11-12 (presenting graphical representation of differences state-to-state of subprime mortgage loan characteristics).

⁸⁷ Frank Partnoy et. al., *The Promise and Peril of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007).

derivative is the credit default swap (CDS).⁸⁸ A CDS is “a bilateral contract that enables an investor to buy protection against the risk of default of an asset [generally] issued by a [corporation or bank].”⁸⁹ For example, a bank that lends millions to a company may wish to hedge their risk against the company defaulting on the loan.⁹⁰ The bank enters a CDS with a third-party.⁹¹ The third-party pays the bank if the company defaults and the bank will pay the third-party if the company does not default.⁹² CDS account for a large part of the credit derivatives market.⁹³ “The primary purpose of credit derivatives is to enable the efficient transfer and repackaging of credit risk.”⁹⁴ Firms use CDS to “bet on a debt issuer’s bankruptcy, default, or restructuring.”⁹⁵ Thus, CDS allow banks and other market participants to hedge their risks against borrowers.⁹⁶ CDS lower the potential costs for a lender of a borrower’s default.⁹⁷ Former Federal Reserve Chairman Alan Greenspan credited CDS with preventing losses from spreading to the financial sector during the scandals of Enron and WorldCom.⁹⁸

MBS were further purchased and pooled into credit derivatives known as collateralized debt obligations (“CDO”).⁹⁹ A cash flow CDO purchases fixed income assets, such as MBS, to sell in the market after enhancing the assets cre-

88 See *id.* at 1021

89 Dominic O’Kane, Lehman Brothers, *Credit Derivatives Explained* 25, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.129.429&rep=rep1&type=pdf> (last visited Aug. 11, 2010) (explaining CDS operation).

90 See Partnoy, *supra* note 87, at 1021-22 (providing example of CDS).

91 See *id.*

92 See *id.* (explaining CDS operation).

93 See O’Kane, *supra* note 89, at 3 (noting importance of CDS in chain of financial instruments).

94 *Id.*

95 Partnoy, *supra* note 87, at 1021.

96 See *id.* at 1023 (listing benefits of CDS to companies).

97 See *id.* at 1023-24 (discussing CDS benefits to lenders).

98 See *id.* at 1024 (stating benefits of CDS when financial sector was faced with scandals). According to Greenspan, credit derivatives “appear to have effectively spread losses from defaults by Enron, Global Crossing, Railtrack, WorldCom, and Swissair.” Alan Greenspan, Chairman, Fed. Res. Bd, Address before the Council on Foreign Relations, Washington, D.C.: International Financial Risk Management (Nov. 19, 2002) <http://www.federalreserve.gov/boarddocs/Speeches/2002/20021119/default.htm> (last visited Aug. 7, 2010).

99 See Rosen, *supra* note 39 (discussing RBMS securitization process); U.S. Securities & Exchange Commission, *Collateralized Mortgage Obligation*, <http://www.sec.gov/answers/tcmos.htm> (last visited Aug. 7, 2010) (defining collateralized mortgage obligations). CMOs are issued through Real Estate Mortgage Investment Conduits (REMICs) for tax and accounting advantages. See SECURITIES INDUSTRY & FINANCIAL MARKETS ASS’N, *The CMO: An Overview*, <http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=24> (last visited Aug. 7, 2010).

dit.¹⁰⁰ Bonds or certificates issued by cash flow CDOs included many of the same innovations as MBS such as tranching, subordination, overcollateralization, and excess spread to enhance the credit.¹⁰¹ These credit enhancement techniques allowed cash flow CDOs to buy low-rated MBS to repackage and sell.¹⁰²

CDOs can be a hybrid of “cash flow” and “synthetic.”¹⁰³ A “synthetic” CDO is composed of credit derivatives.¹⁰⁴ A synthetic CDO, consisting of several CDS with third parties, creates “synthetic exposure to the outstanding debt” of several companies.¹⁰⁵ Cash flow, synthetic and hybrid CDOs were further purchased and pooled into additional CDOs, known as CDO² or CDO-squared.¹⁰⁶ No data exists explaining the extent of CDOs’ exposure to subprime risk.¹⁰⁷ CDS contracts may have also resulted in the amplification in the amount of CDO exposure.¹⁰⁸ The exposure problem is compounded by the lack of transparency in the derivatives market.¹⁰⁹ In the end, securitization built upon other securitization and derivatives written upon securitized assets made it impossible for investors to examine the underlying assets in CDO portfolios.¹¹⁰

Companies purchased CDOs through off-balance sheet Structured Investment Vehicles (“SIV”).¹¹¹ “An SIV is a limited-purpose operating company that undertakes arbitrage activities by purchasing mostly highly rated medium- and long-term fixed income assets and funding itself with cheaper, mostly shorter,

100 See Rosen, *supra* note 39 (defining CDOs).

101 See *id.* at n.5 (providing analysis of CDOs).

102 See *id.* (reporting on CDO issuers purchase of low-rated securities).

103 See Gorton, *supra* note 6, at 37 (providing discussion of CDOs).

104 See Partnoy, *supra* note 87, at 1022 (discussing differing CDOs). Credit default swaps are used for hedging risk, speculating, or arbitrage. See *id.* at 1022.

105 *Id.*

106 See Martin, *supra* note 65, at 2 (describing CDOs).

107 See Gorton, *supra* note 6, at 39 (“It is also notable what data are missing. There is no data on the amount of subprime exposure in CDOs, whether cash or synthetic.”). *Id.*

108 See Jody Shenn, *Overlapping Subprime Exposure Mask Risks of CDOs*, *Moody’s Says*, Bloomberg.com, Apr. 4, 2007, <http://www.bloomberg.com/apps/news?pid=20601170&sid=aszosOrxVmjk&refer=home> (last visited Aug. 7, 2010) (explaining role of credit default swaps in crisis). Although no new risk is created through the synthetic derivative market, the risk exposure increases. See Gorton, *supra* note 6, at 42.

109 See Gorton, *supra* note 6, at 43 (noting difficulty in assessing where CDO tranches ended). The derivative market is largely unregulated resulting in asymmetric information. See Partnoy, *supra* note 92, at 1036-1037.

110 See Martin, *supra* note 65, at 10-11 (discussing problems with derivative market). “CDO investors and other investors in other instruments that have CDO tranches in their portfolios (so called CDO squares or CDO²) cannot penetrate the chain backwards and value the chain based on the underlying mortgages.” *Id.* at 11.

111 See Gorton, *supra* note 6, at 44 (stating SIVs role in CDO dispersal).

highly rated [commercial paper] and [medium term notes].¹¹² Thus, SIVs leveraged themselves by borrowing short and purchasing long assets.¹¹³ SIVs were purchasers of subprime CDO tranches and were exposed to a great deal of subprime risk.¹¹⁴ During the Credit Crisis, the majority of SIVs were put back onto their firm's balance sheets, restructured, or defaulted.¹¹⁵

Information on subprime risk became available to the market in the form of the ABX.HE indices ("ABX").¹¹⁶ The ABX was created by Markit Partners in January of 2006.¹¹⁷ The ABX tracks CDS referencing twenty equally-weighted MBS transactions.¹¹⁸ Investors use the ABX to trade subprime CDS.¹¹⁹ Thus, the ABX allowed investors to trade on the risk of subprime default through CDS.¹²⁰ The ABX serves as a barometer of investor confidence in subprime mortgages.¹²¹ "Changes in investor views about the risk of the mortgage loans over time will affect the price at which investors are willing to buy or sell credit protection [on the ABX]."¹²² Thus, the ABX played a key role in disseminating information regarding investor confidence in subprime risk.¹²³ In 2007 investors ran for protection from subprime risk by purchasing CDS on the ABX causing ABX prices to dramatically fall.¹²⁴

III. RELEVANT SECURITIES LAW

The majority of claims arising out of the 2007 Credit Crisis involve alleged violations under Securities and Exchange Commission ("SEC") Rule 10b-5 and Section 10(b) of the Securities Act of 1934, and Sections 11 and 12(a)(2) of the Securities Act of 1933.¹²⁵ Congress promulgated the acts "to insure honest securities markets and thereby promote investor confidence" after the market crash of

112 *Id.* SIVs are different from SPEs in that they are managed and marked-to-market. *See id.*

113 *See id.* at 44 (describing SIVs).

114 *See id.* at 43 (representing graphically the estimated holders of CDO tranches).

115 *See id.* at 82 (listing SIV outcomes).

116 *See id.* at 3 (stating ABX's role in solving information problem of securitization).

117 *See id.* at 42 (describing ABX).

118 *See* Ingo Fender & Martin Scheicher, *The ABX: How Do the Markets Price Subprime Mortgage Risk?*, BIS Quarterly Review, September, 2008 available at <http://ssrn.com/abstract=1473648>.

119 *See* Gorton, *supra* note 6, at 42. The ABX comprised of five different indices; differentiated by credit rating: AAA, AA, A, BBB, and BBB-. *See* ASHCRAFT, *supra* note 32, at 26.

120 *See* Gorton, *supra* note 6, at 42 (discussing synthetic attributes of ABX).

121 *See* ASHCRAFT, *supra* note 32, at 27 (explaining purpose of ABX).

122 *Id.*

123 *See* Gorton, *supra* note 6, at 3 (stating role of ABX in Credit Crisis).

124 *See id.*

125 *See* Bethel, *supra* note 11, at 3 (stating causes of action by plaintiffs in subprime litigation).

1929.”¹²⁶ To state a securities fraud claim, the plaintiff must prove: (1) a material misrepresentation or omission; (2) scienter, i.e. wrongful intent; (3) connection to the purchase or sale of the security; (4) reliance; (5) economic loss; and (6) causation.¹²⁷

SEC Rule 10b-5 imposes liability on any person who, in a registration form makes, “an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security.”¹²⁸ Section 11 of the Securities Act of 1933 imposes liability upon any person who makes an untrue statement of material fact or omits a material fact, required to be stated or necessary to make the statements not misleading, in a registration statement.¹²⁹ Section 12(a)(2) “imposes liability upon any person who ‘offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstance under which they were made, not misleading.’”¹³⁰

IV. SUBPRIME LENDING AND FRAUD: EXAMINING THE ALLEGED RELATIONSHIP

A. Originate-to-Distribute and the Subprime Lawsuit Narrative

The majority of subprime related lawsuits blame the financial markets collapse and their securities devaluation on the originate-to-distribute model of banking.¹³¹ Some commentators also blame weaknesses in the originate-to-distribute model for the Credit Crisis.¹³² The originate-to-distribute model differs

¹²⁶ SEC v. Zandford, 535 U.S. 813, 819 (2002) (quoting United States v. O’Hagan, 521 U.S. 642, 658 (1997)).

¹²⁷ See Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005) (listing basic required elements of securities claim).

¹²⁸ 15 U.S.C.S. § 77k (2010).

¹²⁹ See 15 U.S.C.S. § 77k(a) (imposing civil liability for false or misleading statements made in registration statement).

¹³⁰ Recupito v. Prudential Secs., Inc., 112 F. Supp. 2d 449, 454 (D.C. Md. 2000) (quoting 15 U.S.C. § 77l(a)(2)).

¹³¹ See, e.g., Atlas, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming misrepresentations regarding companies’ core business for stock inflation and subsequent devaluation); *New York State Teachers’*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (stating basis for complaint).

¹³² See Quinn, Brian J. M., *The Failure of Private Ordering and the Financial Crisis of 2008*, NEW YORK UNIVERSITY JOURNAL OF LAW AND BUSINESS, Vol. 5, p. 549, 2009; (Boston College Law School Legal Studies Research Paper No. 177, April 22, 2010), available at <http://ssrn.com/abstract=1354669> (describing role of originate-to-distribute in crisis); see also S.L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 387 (2008) (analyzing originate-to-distribute and potential solutions).

from the traditional lend and hold approach of banking where the bank lent to the borrower and held onto the loan until full payment.¹³³ In the originate-to-distribute model, the originator of a loan processes the loan for a fee and sells the rights of payment to a third party.¹³⁴ This allows the originator to hand off the risk of repayment to the third party.¹³⁵ Thus, “[u]nder this [originate-to-distribute] model lenders originate loans that are then distributed through securitization such that the lender retains little or no exposure to the loan. This change, many now argue, gave rise to the problems that are at the very heart of the credit crisis.”¹³⁶

According to proponents of the originate-to-distribute hypothesis, profit maximizing behavior resulted in lower underwriting standards thereby increasing the risk of systematic mortgage default.¹³⁷ Consequently, originators became focused on the fees from origination volume instead of the underlying loan quality.¹³⁸ Reserve Chairman Ben Bernanke, in reference to the crisis, stated that “[t]he revenues of the originators of subprime mortgages were often tied to loan volume rather than to the quality of the underlying credits, which induced some originators to focus on the quantity rather than the quality of the loans being passed up the chain.”¹³⁹ Therefore, the originate-to-distribute theory of the crisis posits that the reduced incentive of lenders to monitor loan quality resulted in weak loans prone to default.¹⁴⁰ When housing prices soured the inferior loans defaulted in mass.¹⁴¹ The proliferation of the inferior loans into the financial system through securitization magnified the damage to the economy.¹⁴² Former

133 See Quinn, *supra* note 132, at 23 (distinguishing originate-to-distribute and lend-to-hold).

134 See *id.* (explaining transfer of risk in originate-to-distribute model).

135 See *id.* at 22-23 (citing Annand K. Bhattaharya, Frank Fabozzi, & S. Esther Chang, *Overview of the Mortgage Market* in HANDBOOK OF MORTGAGE-BACKED 4 (Frank Fabozzi, ed. 2001) (defining originate-to-distribute).

136 Martin, *supra* note 70, at 9.

137 See Quinn, *supra* note 132, at 27 (“The front-loaded structure of incentives in the originate-to-distribute model, however, induced originators of mortgages to lower lending standards and continue to underwrite mortgages precisely when they should have been cutting back.”).

138 See Frederic S. Mishkin, Governor of the Bd. Of Governors of the Federal Reserve System, Speech at the U.S. Monetary Policy Forum, New York: *On “Leveraged Losses: Lessons from the Mortgage Meltdown”* (Feb. 29, 2008) <http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm> (last visited Aug. 11, 2010) (discussing misaligned incentives of lenders).

139 Ben Bernanke, Chairman of the Bd. Of Governors of the Federal Reserve System, Address at the Federal Reserve Bank of Chicago’s Annual Conference on Bank Structure and Competition, Chicago, Illinois: *Risk Management in Financial Institutions* (May 15, 2008),

<http://www.federalreserve.gov/newsevents/speech/bernanke20080515a.htm> (last visited Aug. 11, 2010).

140 See Mishkin, *supra* note 138 (stating basic theory behind crisis on originate-to-distribute).

141 See *id.* (providing history of crisis).

142 See *id.* (discussing role of structured credit products within crisis).

United States Secretary of the Treasury Henry Paulson remarked, “[t]his turbulence wasn’t precipitated by problems in the real economy. This came about as a result of some bad lending practices.”¹⁴³

B. A ‘Fusillade’ of Cautionary Statements

Many subprime plaintiffs blame their economic losses on poor lending practices.¹⁴⁴ Subprime plaintiffs organize their securities fraud claims based upon alleged misrepresentations companies made about their lending procedures and other loan related practices.¹⁴⁵ Cautionary statements in prospectuses and registrations statements, however, put potential plaintiffs on notice of the risks associated with the subprime mortgage industry.¹⁴⁶ The United States District Court for the District of Massachusetts dismissed all claims by purchasers of mortgage pass-through certificates issued by Nomura Asset Acceptance Corporation (“Nomura”).¹⁴⁷ In *Plumbers’ Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, plaintiffs alleged that defendants were liable under Sections 11, 12(a)(2) and 15 of Securities Act of 1933.¹⁴⁸ Nomura’s certificates were significantly backed by Alt-A loans and the certificates suffered severe losses following the collapse of the subprime market.¹⁴⁹ On July 17, 2007, Moody’s Investors Services announced that it might downgrade the certificates’ ratings.¹⁵⁰ This action resulted in significant losses on the certificates and Nomura closing its U.S. mortgage loan business.¹⁵¹

¹⁴³ Reuters, *Paulson Says Subprime Woes Will Linger*, Reuters.com, Sept. 12, 2007, <http://www.reuters.com/article/idUSWBToo756020070912> (last visited Aug. 7, 2010).

¹⁴⁴ *Plumbers’ Union*, 658 F. Supp. 2d 299, 303 (D.Mass. 2009) (listing alleged misrepresentations within registration statements and prospectuses); *Atlas*, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming inflated stock price on misrepresentations regarding companies’ core business); *New York State Teachers’*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (blaming misrepresentations for common stock devaluation).

¹⁴⁵ See *Atlas*, 556 F. Supp. 2d at 1149 (“The gravamen of Plaintiff’s Complaint is that Defendants concealed Accredited’s true financial condition and made materially false and misleading statements regarding the company’s operations and income, as a result, artificially inflated the price of Accredited’s stock during the class period.”).

¹⁴⁶ See *Plumbers’ Union*, 658 F. Supp. 2d at 305 (D.Mass. 2009) (discussing problems with plaintiffs’ complaint because of cautionary language included in defendants’ prospectuses and registration statements).

¹⁴⁷ See *id.* at 310 (D.Mass. 2009) (stating dismissal of case).

¹⁴⁸ See *id.* at 299 (stating cause of action).

¹⁴⁹ See *id.* (describing problems company had following subprime market crisis). Nomura expected losses ranging from \$340 to \$510 million. See *id.*

¹⁵⁰ See *id.* (noting Moody’s involvement in downgrading of certificates).

¹⁵¹ See *id.* (reporting Nomura’s response to potential of Moody’s rating downgrade).

Plaintiffs' alleged material misrepresentations and/or omissions in Nomura's registrations statements and prospectus supplements.¹⁵² Plaintiffs argued that Nomura's underwriting and loan originating standards were focused on volume instead of quality.¹⁵³ Defendants' prospectuses stated that prospective borrowers were required to complete an application so defendants could determine the credit risk of the borrower.¹⁵⁴ Additionally, defendants' prospectus stated that a "key" originator "adhered to 'underwriting guidelines [that] are primarily intended to evaluate the prospective borrower's credit standing and ability to repay the loan,' and that these guidelines 'are applied in a standard procedure that is intended to comply with federal and state laws and regulations.'"¹⁵⁵ Plaintiffs argued that these statements were false when made by Nomura because Nomura did not filter out potentially risky borrowers using such methods.¹⁵⁶ The court, however, stated that statements in Nomura's prospectuses warned the plaintiffs of lower than average credit standards.¹⁵⁷ Nomura's prospectuses stated,

The underwriting standards applicable to the Mortgage Loans . . . may or may not conform to Fannie Mae or Freddie Mac guidelines. As a result, the Mortgage Loans may experience rates of delinquency, foreclosure and borrower bankruptcy that are higher, and that may be substantially higher, than those experienced by mortgage loans underwritten in strict compliance with Fannie Mae or Freddie Mac guidelines.¹⁵⁸

¹⁵² See *id.* at 305 - 306 (alleging misrepresentations and/or omissions in registration and prospectus statements).

¹⁵³ See *id.* (arguing that underwriting and loan origination standards were opposite those purported in prospectuses and registrations statements).

¹⁵⁴ See *id.*

Generally, each borrower will have been required to complete an application designed to provide to the original lender pertinent credit information concerning the borrower. As part of the description of the borrower's financial condition, the borrower generally will have furnished certain information with respect to its assets, liabilities, income (except as described below), credit history, employment history and personal information . . .

Based on the data provided in the application and certain verifications (if required), a determination is made by the original lender that the borrower's monthly income (if required to be stated) will be sufficient to enable the borrower to meet their monthly obligations on the mortgage loan and other expenses related to the property . . . (quoting Complaint).

Id.

¹⁵⁵ *Id.*

¹⁵⁶ See *id.* at 305 (stating plaintiffs' argument that statements in prospectuses and registration statements were false and misrepresentative).

¹⁵⁷ See *id.* (quoting language from prospectuses demonstrating relaxed credit standards).

¹⁵⁸ *Id.*

The court stated that the “fusillade” of cautionary language and offering materials refuted the plaintiffs’ contention that they were misled as to the underwriting and loan originating standards of Nomura.¹⁵⁹ This ruling confirms that investors were put on notice of the risks associated with subprime MBS.

Plaintiffs alleged that defendants misrepresented their LTV ratios because they were not within the Uniform Standards of Professional Appraisal Practice as claimed in defendants’ registration statements.¹⁶⁰ The court found these allegations unsubstantiated because plaintiffs’ allegations relied on general testimony on industry standards and differing appraisal methods.¹⁶¹ Next, the court rejected the plaintiffs’ argument on material misrepresentations from statements about loan delinquencies greater than 30 days.¹⁶² Only two loans out of 1,774 loans were delinquent for more than 30 days.¹⁶³ Thus, the court reasoned that the misrepresentation that no loans were delinquent for more than 30 days was not material.¹⁶⁴

Finally, plaintiffs alleged misrepresentations on the ratings of the certificates.¹⁶⁵ The court stated that the plaintiffs’ allegations amounted to an inference that “eventualities must have been known (or knowable) to defendants on the effective date of the registration statement” based on after the fact “insider” admissions.¹⁶⁶ As noted by the court and the defendants’ registration statements, “[a] security rating is not a recommendation to buy, sell or hold securities.”¹⁶⁷ The court found that the plaintiffs did not sufficiently allege any securities violations against defendants and the court dismissed all claims.¹⁶⁸

All of the mortgage loans have been originated either under FNBN’s “full” or “alternative” underwriting guidelines (i.e., the underwriting guidelines applicable to the mortgage loans typically are less stringent than the underwriting guidelines established by Fannie Mae or Freddie Mac primarily with respect to the income and/or asset documentation which borrower is required to provide).

Id.

159 *See id.* at 307 (“Plaintiffs’ argument that they were not on notice of the originator’s “soft” underwriting practices begs credulity.”).

160 *See id.* (stating that plaintiffs’ alleged misrepresentations and/or omissions regarding defendants loan-to-value appraisals).

161 *See id.* at 307-308 (rejecting plaintiffs’ argument of loan-to-value appraisal misrepresentations).

162 *See id.* at 308 (discussing loan delinquencies in trust pools).

163 *See id.* (noting amount of loans delinquent beyond 30 days). The amount of loans delinquent accounted for 0.7 percent of the loan vintage. *See id.*

164 *See id.* (finding loan delinquency misrepresentation immaterial).

165 *See id.* 310 (alleging misrepresentations about certificates’ ratings).

166 *Id.* According to the court, “plaintiffs were duly cautioned that “[t]he security ratings assigned to the Offering Certificates should be evaluated independently from similar ratings on other types of securities.” *Id.*

167 *Id.*

168 *See id.* (stating holding of case dismissing all claims against defendants).

The *Nomura* ruling confirms that investors were put on notice of the many risks associated with subprime MBS.¹⁶⁹ Investors were provided “numerous warnings” and were told of “originator’s ‘soft’ underwriting practices.”¹⁷⁰ Therefore, subprime MBS originators did not commit securities fraud to investors because the investors were given such warnings.¹⁷¹

C. Economic Research on Lending Standards

There is a difference of opinion between economists on whether lending standards materially relaxed prior to the Credit Crisis.¹⁷² Some economists argue that lending standards radically deteriorated due to the originate-to-distribute banking model.¹⁷³ According to these commentators, lenders originated as many loans as possible because the risk was subsequently sold to third-parties.¹⁷⁴ One study connected the proportion of default rates to the proportion of company’s originate-to-distribute banking.¹⁷⁵ According to the study, the more a bank participated in the originate-to-distribute market, the harder it became when market conditions deteriorated to sell the loans.¹⁷⁶ Lenders in the originate-to-distribute market experienced a greater proportion of borrower default and

¹⁶⁹ See *id.* at 306-307 (acknowledging information provided to investors of risks associated with MBS).

¹⁷⁰ See *id.* (describing underwriting practices and warnings provided to investors regarding such practices).

¹⁷¹ See *id.*

¹⁷² Compare Geetesh Bhardwaj & Rajdeep Sengupta, *Where’s the Smoking Gun? A Study of Underwriting Standards for US Subprime Mortgages* 3, (Federal Reserve Bank of St. Louis, Working Paper 2008-036B, 2008), available at <http://research.stlouisfed.org/wp/2008/2008-036.pdf> (finding no deterioration in lending practices leading up to Credit Crisis) with Benjamin J. Keys, et. al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans*, (EFA 2008 Athens Meetings Paper, Dec. 25, 2008), available at <http://ssrn.com/abstract=1093137> (noting relaxed lending standards based on FICO scores).

¹⁷³ See, e.g., Amiyatosh Purnanandam, *Originate-to-Distribute Model and the Subprime Mortgage Crisis*, April 27, 2009, at 13, available at http://webuser.bus.umich.edu/amiyatos/subprime_march09.pdf (connecting originate-to-distribute mode with weakening lending standards); Benjamin J. Keys, et. al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans* 1, (EFA 2008 Athens Meetings Paper), available at <http://ssrn.com/abstract=1093137> (“By creating distance between a loan’s originator and the bearer of the loan’s default risk, securitization may have potentially reduced lenders’ incentives to carefully screen and monitor borrowers.”).

¹⁷⁴ See Purnanandam, *supra* note 178, at 2 (stating incentive to relax credit screening when originating subprime loans).

¹⁷⁵ See *id.* at 29 (concluding results of research finding relationship between delinquencies and originate-to-distribute banking).

¹⁷⁶ See *id.* at 3 (“We first confirm that banks with large quantity of origination in the immediate pre-disruption period were unable to sell their OTD loans in the post-disruption period.”).

chargeoffs suggesting lower quality loans.¹⁷⁷ Another study suggests that loans originated with a greater likelihood of securitization defaulted at a higher rate than loans originated with little likelihood of securitization.¹⁷⁸ Borrowers with a FICO score slightly above 620 are considered liquid and likely to be securitized.¹⁷⁹ Looking at loans above this mark and loans below the mark, the study states that loans above the threshold defaulted with greater frequency than loans below the threshold.¹⁸⁰ The FICO score ordinarily measures a borrowers' credit risk.¹⁸¹ The study argues that if the FICO score is higher yet defaults with greater frequency the loan must be a consequence of relaxed screening.¹⁸² Therefore, relaxed lending standards created a higher rate of default.¹⁸³

Other economists, however, argue that underwriting standards in the United States neither deteriorated over time nor had a great effect on the market when compared to the consequences of real estate prices.¹⁸⁴ Many plaintiffs argue that underwriting standards started to relax and decline after 2004 as evidenced by mortgage foreclosures and delinquencies beginning in 2005.¹⁸⁵ In one study, researchers demonstrated that underwriting standards from 1998-2007 did not decline, specifically after 2004.¹⁸⁶ The authors do not assess whether lending standards were low before 1998; rather, the authors only analyzed whether lending standards deteriorated during this specific time period.¹⁸⁷ According to their research, "the underwriting process attempted to adjust riskier borrower characteristics with lower loan-to-value ratios (and higher mortgage rates)."¹⁸⁸ Even so, dramatic changes did not occur in lending standards post-2004 because while some dimensions of underwriting weakened, other dimen-

¹⁷⁷ See *id.* at 3 ("[T]hese results suggest that OTD loans were of inferior quality and banks that were stuck with these loans in the post-disruption period had disproportionately higher chargeoffs and borrower defaults.").

¹⁷⁸ See Keys, *supra* note 172, at 3 (stating that easily securitized loans defaulted with greater frequency than other loans.)

¹⁷⁹ See *id.* at 2 (providing rule of thumb for study).

¹⁸⁰ See *id.* at 3 (noting default rates higher among greater FICO scored borrowers).

¹⁸¹ See *id.* at 2 (describing FICO score importance for investors, lenders, and other market participants).

¹⁸² See *id.* at 3 (describing relationship between defaults and FICO score).

¹⁸³ See Purnanandam, *supra* note 178, at 29 (discussing originate-to-distribute hypothesis).

¹⁸⁴ See Bhardwaj, *supra* note 172, at 3 ("Our results show that the hard information available on mortgage originations does not reveal deterioration in underwriting standards for subprime originations, particularly after 2004.").

¹⁸⁵ See *In re New Century*, 588 F. Supp. 2d 1206 (C.D. Cal. 2008) ("New Century Complaint") (stating claim of poor lending standards).

¹⁸⁶ See Bhardwaj, *supra* note 172, at 3 (stating that lending standards did not weaken from 1998-2007).

¹⁸⁷ See *id.* at 4 (noting that research did not analyze whether standards were poor to begin with).

¹⁸⁸ *Id.* at 22.

sions strengthened.¹⁸⁹ Although lending standards declined in some areas, it improved in others.¹⁹⁰ Documentation of borrowers may have lowered, whereas FICO scores increased.¹⁹¹ Moreover, using counterfactual analyses, the study argues that had loans underwritten in 2005 been underwritten in 2001 or 2002, the loans would have performed *significantly better* than loans actually originated in 2001 or 2002 had housing prices behaved similarly.¹⁹² Overall, the study states that lending standards did not drastically weaken in the subprime market from 1998-2004.¹⁹³ Another study notes that borrower characteristics improved while documentation may have fallen.¹⁹⁴

Several other economists point to real estate price depreciation as the greatest factor in the Credit Crisis, not relaxed lending standards.¹⁹⁵ Lending standard deviations, if correct, may have been immaterial to the losses suffered on MBS.¹⁹⁶ The real problem was housing prices.¹⁹⁷ Thus, the extreme decline in housing prices is likely to blame for subprime default, and it would not matter if underwriting practices relaxed because there would be no causation to the alleged losses.¹⁹⁸ Consequently, securities fraud would not explain the losses suffered by investors.

189 See *id.* at 22 (finding no dramatic changes in lending standards post-2004).

190 See *id.* at 3 (describing multi-dimensional nature of risk). Ex ante risk in one borrower can be mitigated through higher standards along another dimension. See *id.* Moreover, credit risk is affected by both the borrower's credit characteristics and the mortgage's characteristics. See *id.*

191 See *id.* at 3 (providing examples of increasing risk factors and decreasing risk factors).

192 See *id.* at 4 (“[I]f loans underwritten in 2005 (or 2006 or 2007) were originated in 2001 or 2002, then they would have performed significantly better on average than loans underwritten in 2001 or 2002.”).

193 See *id.* at 3 (highlighting conclusion of study).

194 See Charles D. Anderson, Dennis Capozza & Robert Van Order, *Deconstructing a Mortgage Meltdown: A Methodology for Decomposing Underwriting Quality*, May 29, 2009, at 21, <http://ssrn.com/abstract=1411782> (last visited Aug. 11, 2010) (discussing credit characteristics of subprime borrowers before Credit Crisis).

195 See, e.g., Dean Corbae & Erwan Quintin, *Mortgage Innovation and the Foreclosure Boom*, Oct. 23, 2009, at 5, <http://sites.google.com/site/deancorbae/research/foreo6161otc.pdf?attredirects=0> (last visited Aug. 11, 2010) (noting importance of housing prices in Credit Crisis); Christopher J. Mayer, Karen M. Pence & Shane M. Sherlund, Federal Reserve Board, Washington, D.C., *The Rise in Mortgage Defaults*, available at <http://www.federalreserve.gov/pubs/FEDS/2008/200859/200859pap.pdf> (“We find substantial evidence that declines in house prices are a key factor in the current problems facing the mortgage market.”); Kristopher S. Gerardi, et. al., *Making Sense of the Subprime Crisis* 6, (Federal Reserve Bank of Atlanta Working Paper No. 2009-2, Feb. 2009), available at <http://www.frbatlanta.org/filelegacydocs/wp0902.pdf> (“One of our key findings is that most of the uncertainty about losses stemmed from uncertainty about the evolution of house prices and not from uncertainty about the quality of the underwriting.”).

196 See *id.*

197 See Mayer, *supra* note 195 (discussing falling housing prices impact on economy).

198 See *id.*

D. *Misplaced Anger: What Really Happened*

1. The Role of Securitization

The complexity of financial instruments created a loss of information in financial transactions.¹⁹⁹ According to one commentator,

the increased complexity introduced to the market, combined with a decided lack of transparency, caused a high proportion of skilled investors to make poor decisions. Financial institutions overestimated their ability to disseminate values and comprehend risk. This same lack of transparency and true understanding of the market led to the knee-jerk reaction whereby investors fled and refused to invest when the Credit Crisis struck.²⁰⁰

As noted above, investors were not able to keep track of the risk underlying securities, derivatives and SIVs. Declining housing prices substantially increased the rate of default amount recent vintages of subprime loans.²⁰¹ Market participants did not know the true value of their portfolios because of their inability to track back to the individual loans pooled together in the MBSs, CDOs, and SIVs.²⁰² The complexity in the financial chain damaged their ability to run valuations.²⁰³ Additionally, the lack of transparency created uncertainty in the market

¹⁹⁹ See Gorton, *supra* note 6, at 49 (arguing that complexity of structured finance resulted in a loss of information); see generally, Jean-Pierre Landau, Introductory remarks at the Conference on The Macroeconomy and Financial Systems in Normal Times and in Times of Stress: Complexity and the Credit Crisis (June 8, 2009), <http://www.banque-france.fr/gb/instit/telechar/discours/2009/090608.pdf> (last visited Aug. 4, 2010) (pointing to complexity of finance as cause of Credit Crisis).

²⁰⁰ Aaron Unterman, *Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 72 (2009).

²⁰¹ See Gorton, *supra* note 6, at 34 (providing example of different MBS deals and the consequences of housing prices). According to one commentator, “a sudden reversal in house price appreciation increased default in this market because it made this prepayment exit option cost-prohibitive.” Bhardwaj, *supra* note 172, at 28. Moreover, the subprime securitization structure required stable or a downward trend in interest rates to sustain itself. When the Fed began to raise interest rates in 2004-5, demand for subprime borrowing cooled leading to a decline in real estate prices. Declines in real estate prices had the double effect of reducing incentives for servicers to refinance subprime borrowers as the fixed terms of those mortgages reset to variable rates. As marginal borrowers, now forced to pay higher rates, began to default on their mortgages, the air quickly came out of the real estate bubble as subprime borrowers were forced into foreclosure. Quinn, *supra* note 123, at 20-21. See also Corbae *supra* note 195 (“Mortgage innovation, in other words, makes the economy much more sensitive to price shocks.”). Kristopher Gerardi, et. al., *Decomposing the Foreclosure Crisis: House Price Depreciation versus Bad Underwriting* 1, (Working Paper 2009-25, Sept. 2009), available at <http://www.frbatlanta.org/filelegacydocs/wp0925.pdf> (arguing that Credit Crisis resulted from house price depreciation).

²⁰² See Gorton, *supra* note 6, at 45 (stating impossibility of an investor to look through CDO to determine subprime risk exposure).

²⁰³ See *id.* at 61 (“The structure itself does not allow for valuation based on the underlying mortgages, as a practical matter.”).

because no one knew the “toxic assets” final resting spot or the extent of a market participant’s subprime risk exposure.²⁰⁴ Because no one knew where the assets lay it became a guessing game as to who had exposed themselves to default risk.²⁰⁵ Therefore, complexity in financial transactions and lacking transparency created compounded asymmetric and lack of information problems.²⁰⁶

2. The Housing Bubble and Monetary Policy

Historically, asset-price increases are “encouraged” by relaxed monetary policies.²⁰⁷ Housing prices are hyper sensitive to interest rate changes because housing is incredibly leveraged.²⁰⁸ The Taylor Rule, named after Stanford economist John B. Taylor, is a suggestion for the Federal Reserve or any central bank on setting the short-term interest rate.²⁰⁹ Beginning in 2001, the Federal Reserve lowered short-term interest rates well below the recommended Taylor Rule for an unusually extended amount of time.²¹⁰ Taylor argues that housing prices became inflated because of the unusually low short-term interest rates.²¹¹ This monetary policy made it attractive for consumers to borrow as credit became easier to obtain.²¹² It became very rational for consumers to purchase homes because the lending was in essence subsidized by the government.²¹³ Consumers purchased secondary homes and home speculation became a thriving business.²¹⁴ In Miami, for example, real estate speculators saw profit margins of twenty to

204 See *id.* at 45 (stating information problem of securitization).

205 See *id.* at 3-4 (describing lack of confidence among market participants).

206 See Untermann, *supra* note 200, at 72 (detailing problems that created Credit Crisis).

207 Jean Claude Trichet, President European Central Bank, Speech at the fifth MAS Lecture: Asset Price Bubbles and Monetary Policy (Wednesday 8 June 2005) http://www.mas.gov.sg/news_room/statements/2005/Speech_by_Mr_Jean_Claude_Trichet_for_MAS_Lecture.html (last visited Aug. 11, 2010) (stating historical relationship between monetary policies and asset prices).

208 See MORRIS, *supra* note 10, at 64 (discussing relationship between housing prices and interest rates).

209 See TAYLOR, *supra* note 4, at 67 (defining Taylor Rule).

210 See *id.* at 3 (noting importance of following Taylor Rule).

211 See *id.* at 3-4 (providing counterfactual to demonstrate correlation between interest rates and housing boom and bust).

212 See *id.* at 11 (stating attractiveness of short-term interest rates for potential home owners).

213 See Adam Levitin, Andrey Pavlov & Susan Wachter, *Securitization: Cause or Remedy of the Financial Crisis* 9 (Georgetown Law and Economics, Research Paper No. 1462895, Aug. 27, 2009) available at http://realestate.wharton.upenn.edu/newsletter/pdf/Levitin_et_al.pdf (discussing ease of credit for home purchasers).

214 See Les Christie, Homes: Big Drop in Speculation, CNN.com, April 30, 2007 http://money.cnn.com/2007/04/30/real_estate/speculators_fleeing_housing_markets/index.htm (last visited Aug. 11, 2010) (describing fall in home speculation with increase in secondary home purchases).

twenty-five percent during the housing boom.²¹⁵ Moreover, during the period of low short-term interest rates the number of ARMs increased to cover one third of the total mortgages issued.²¹⁶ The ARM attracted borrowers with teaser rates.²¹⁷ The ARMs, as stated above, were unique to subprime mortgages. ARMs allowed the lender to decide whether to refinance the loan or extract the recovery value.²¹⁸ From 1997 to 2006, housing prices rose 40% above their traditional long run level.²¹⁹ As housing prices increased, so did housing price inflation.²²⁰ Demand for housing subsequently increased to historic levels.²²¹

During the housing market boom subprime mortgage origination worked very well.²²² Subprime loans originated between 2001 and 2005 performed better than loans originated in 2000.²²³ Subprime loan delinquency and foreclosure rates declined over the same time period because of the increase in housing prices.²²⁴ Moreover, participants in the subprime market considered a decline in housing prices highly unlikely.²²⁵ Many participants believed that price appreciation would continue, even if only at the traditional long run average.²²⁶ The worst case scenario, according to participants, was stagnate growth in prices.²²⁷ One participant gave a decline of five percent in housing prices an overall probability of five percent.²²⁸

²¹⁵ See JustNews.com, Miami's Changing Skyline: Boom Or Bust?, Mar. 11, 2005, <http://www.justnews.com/news/4277615/detail.html> (last visited Aug. 11, 2010) (explaining real estate speculation market in Miami during 2000s).

²¹⁶ See *id.* (indicating growth in ARM market during relaxed monetary policy).

²¹⁷ See John Taylor, Address at the Federal Reserve Bank of Kansas City Policy Panel at the Symposium on Housing, Housing Finance, and Monetary Policy: Housing and Monetary Policy, (September 2007). <http://www.stanford.edu/~johntayl/Housing%20and%20Monetary%20Policy--Taylor--Jackson%20Hole%202007.pdf> (last visited Aug. 11, 2010) (noting ARM teaser rates and ease of credit for borrowers).

²¹⁸ See Gorton, *supra* note 6, at 16 (discussing purpose of ARMs).

²¹⁹ See Anderson, *supra* note 194, at 6 (providing statistics on home price appreciation).

²²⁰ See Taylor, *supra* note 217, at 2 (stating relationship between housing prices and home inflation).

²²¹ See *id.* at 2 (discussing causes of rising real estate prices).

²²² See Bethel, *supra* note 11, at 24 (discussing benefits associated with subprime loan business).

²²³ See *id.* (noting loan performances).

²²⁴ See Bethel, *supra* note 11, at 24 (discussing subprime loan performances).

²²⁵ See Gerardi, *supra* note 195, at 45 (stating prominent views of subprime market participants).

²²⁶ See *id.*

²²⁷ See *id.*

²²⁸ See *id.* at 46 (discussing views of market participants).

Federal Reserve Chairman Bernanke counters that that the housing bubble is not attributable to loose monetary policy.²²⁹ Bernanke states that “only a small portion of the increase in house prices [...] can be attributed to the stance of U.S. monetary policy.”²³⁰ According to Bernanke, subprime lending and the global savings glut are responsible for the housing bubble.²³¹ As noted above, subprime lenders believed that housing prices could only go up. As subprime lending expanded this view became a self-fulfilling prophecy.²³² Additionally, Bernanke argues that the global savings glut increased housing prices.²³³ The global savings glut hypothesis states “that capital inflows from emerging markets to industrial countries can help explain asset price appreciation and low long-term interest rates in the countries receiving the funds.”²³⁴ Greenspan also argues that low long-term interest rates resulting from the global savings glut, not the government’s short-term interest rate, account for the housing bubble.²³⁵

Taylor replied to Bernanke, stating that Bernanke’s argument ignored evidence explaining further the relationship between monetary policy and the housing bubble.²³⁶ Regardless of which theory is correct, for the purpose of this

229 See generally, Ben Bernanke, Speech at the Annual Meeting of the American Economic Association: Monetary Policy and the Housing Bubble (Jan. 3, 2010) <http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.pdf> (last visited Aug. 11, 2010) (arguing that monetary policy did not cause housing bubble).

230 *Id.* at 12-13.

231 See *id.* at 16-19 (stating that housing bubble is attributable to global savings glut and subprime lending).

232 See *id.* at 16-17 (“For a time, rising house prices became a self-fulfilling prophecy, but ultimately, further appreciation could not be sustained and house prices collapsed.”).

233 See *id.* at 18 (explaining global savings glut hypothesis); see also Ben Bernanke, , Speech at the Bundesbank Lecture: *Global Imbalances: Recent Developments and Prospects* (September 11, 2007) <http://www.federalreserve.gov/newsevents/speech/bernanke20070911a.htm> (last visited Aug. 11, 2010) (examining global savings glut hypothesis).

234 Bernanke, *supra* note 236, at 18.

235 See Alan Greenspan, *The Fed Didn’t Cause the Housing Bubble*, WALL STREET J., Mar. 19, 2009, at A15 available at <http://online.wsj.com/article/SB123672965066989281.html> (arguing that low long-term rates accounted for housing bubble); see also Frederic S. Mishkin, *Housing and the Monetary Transmission Mechanism*, Finance and Economics Discussion Series, August 2007, available at <http://www.federalreserve.gov/PUBS/FEDS/2007/200740/200740pap.pdf> (rebuking argument that loose monetary policy created housing bubble).

236 See John Taylor, *The Fed and the Crisis: A Reply to Ben Bernanke*, WALL STREET J., Jan. 10, 2010, available at <http://online.wsj.com/article/SB10001424052748703481004574646100272016422.html> (discussing research pointing to significant relationship between monetary policy and housing bubble); see also Thomas Hoenig, President, Fed. Res. Bank of Kansas City, Address at The Central Exchange Kansas City, Missouri: *The 2010 Outlook and the Patch Back to Stability* (Jan. 7 2010), <http://www.kc.frb.org/speechbio/hoenigpdf/hoenig.01.07.10.pdf> (last visited Aug. 11, 2010) (stating that easy monetary policy contributed to crisis); Marek Jarociński & Frank Smets, *House Prices and the Stance of Monetary Policy* (ECB Working Paper No. 891, Apr. 2008), available at http://ssrn.com/abstract_id=1120167 (“There is also evidence that monetary policy has significant effects on residential investment and house prices and that easy monetary policy designed to stave

article both arguments explain the housing bubble outside of the originate-to-distribute narrative and securities fraud.

3. The Black Swan

A black swan is rare event causing severe consequences.²³⁷ Because the black swan is a rare occurrence people underestimate the risk it presents.²³⁸ Many commentators claim that the current Credit Crisis is a black swan.²³⁹ The United States Supreme Court stated in *Dura Pharmaceuticals v. Broudo*, stated that losses from “changed economic circumstances, changed investor expectations, new industry-specific . . . conditions, or other events, which taken separately or together account for some or all of that lower price” are not recoverable in a securities fraud case.²⁴⁰ As explained above, securitization left MBS and credit derivatives sensitive to housing prices. Housing prices hit their peak in 2006 and started to fall.²⁴¹ Subprime lenders did not believe housing prices could fall so precipitously.²⁴² When housing prices started to fall borrowers became unable to pay or refinance their loans.²⁴³ Foreclosures and delinquencies grew exponentially because the subprime mortgages were not designed for falling home prices.²⁴⁴ Generally, the 2005 MBS vintages passed the credit enhancement triggers

off perceived risks of deflation in 2002 to 2004 has contributed to the boom in the housing market in 2004 and 2005.”)

²³⁷ See Bethel, *supra* note 11, at 26-27 (defining black swan).

²³⁸ See *id.* at 27 (stating relationship of black swan to finance).

The tools we have in quantitative finance do not work in what I call the “Black Swan” domain . . . people underestimate the impact of infrequent occurrences. Just as it was assumed that all swans were white until the first black species was spotted in Australia during the 17th century, historical analysis is an inadequate way to judge risk.”

Id. (quoting NASSIM TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (Random House 2007)).

²³⁹ See, e.g., John Taylor & John Williams, *A Black Swan in the Money Market*, (Federal Reserve Bank of San Francisco Working Paper no. 2008-04), available at <http://www.frbsf.org/publications/economics/papers/2008/wp08-04bk.pdf> (describing Credit Crisis as black swan); Bethel, *supra* note 11, at 26-27.

²⁴⁰ *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336, 343-44 (2005).

²⁴¹ See Press Release, Standard & Poor's, *Home Price Declines Worsen As We Enter the Fourth Quarter of 2008 According to the S&P/Case-Shiller Home Price Indices*, http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_123062.pdf (last visited Aug. 11, 2010).

²⁴² See Gerardi, *supra* note 195, at 45-46 (explaining view among subprime lenders that housing prices could not fall).

²⁴³ See Mishkin, *supra* note 138 (“When the housing market cooled and house prices no longer rose at a rapid pace, these subprime borrowers found themselves unable to either repay their loans or refinance out of them.”) .

²⁴⁴ See Gorton, *supra* note 6, at 51 (“The ability of subprime and Alt-A borrowers to sustain their mortgage payments depends heavily on house price appreciation because of the need for refinancing.

necessary for refinancing, whereas the 2006 MBS vintages did not build enough equity prepay and pass the triggers required for refinancing.²⁴⁵ With rising housing prices the MBS passed its triggers and refinanced; however, when housing prices fell the MBS failed to refinance and lost the credit enhancement for which it was designed.²⁴⁶ The difference between the two MBS illustrates the sensitivity MBS have towards house prices.²⁴⁷ Without house price appreciation the MBS failed to trigger and became delinquent.²⁴⁸ Many mortgage originators and investors took heavy losses on the subsequent credit downgrades.²⁴⁹

The ABX played an important role in informing market participants of the value in subprime MBS and related securities.²⁵⁰ The ABX began to fall in 2007 as banks began to lose confidence in subprime related products.²⁵¹ Market participants started hedging their subprime risk by shorting on the ABX.²⁵² This only magnified the steep fall of the ABX.²⁵³

The housing market entered an unsustainable bubble.²⁵⁴ When housing prices fell so did the value of financial instruments connected to housing.²⁵⁵ The lack of information and complexity within the financial sector from securitization and credit derivatives left market participants unsure of where the risk of these suddenly toxic assets lay.²⁵⁶ Greenspan states, “[i]t is clear that the levels of complexity to which market practitioners, at the height of their euphoria, carried risk-management techniques and risk-product design were too much for even the most sophisticated market players to handle prudently.”²⁵⁷ This loss of in-

When housing prices did not appreciate to the same extent as in the past, and in many areas they have recently gone down, the ability of borrower to refinance has reduced.”).

²⁴⁵ See *id.* at 34 (comparing 2005 and 2006 vintages of Ameriquest Mortgage Securities, Inc.).

²⁴⁶ See *id.* (noting failure of MBS when housing prices failed to rise).

²⁴⁷ See *id.*

²⁴⁸ See *id.*

²⁴⁹ See David Reilly, *Banks' Hidden Junk Menaces \$1 Trillion Purge*, Bloomberg.com, March 25, 2009, http://www.bloomberg.com/apps/news?pid=20601039&sid=akv_p6LBNIIdw&refer=home (Mar. (last visited Aug. 11, 2010) (detailing size of assets soured by subprime collapse).

²⁵⁰ See Gorton, *supra* note 6, at 54 (stating role of ABX in disseminating information to market on subprime risk).

²⁵¹ See *id.* at 57 (describing ABX decline and subsequent conclusions).

²⁵² See *id.* (“In fact, some of the dealer banks themselves, we now know, were shorting the index to hedge their long positions – of course so was everyone.”).

²⁵³ See *id.* (discussing fall of ABX when firms hedged their subprime risk).

²⁵⁴ See TAYLOR, *supra* note 4, at 1 (blaming financial crisis on loose monetary policy).

²⁵⁵ See Gorton, *supra* note 6, at 61 (discussing connection between home values and security values).

²⁵⁶ See *id.* (summarizing loss of information and asymmetric information problem).

²⁵⁷ See Alan Greenspan, *We Need a Better Cushion Against Risk*, FT.com, March 26, 2009, <http://www.ft.com/cms/s/0/9c158a92-1a3c-11de-9f91-0000779fd2ac.html> (last visited Aug. 11, 2010) (discussing risk problem in market).

formation caused a run on SIVs.²⁵⁸ Because SIVs were heavily invested in the financial sector it was unknown the amount of their exposure to subprime risk.²⁵⁹ SIVs were put back onto their firm's balance sheets, restructured, or defaulted.²⁶⁰ Market participants were forced to write-down the significant losses incurred by the subprime assets they held.²⁶¹ The explanation of the causes for the Credit Crisis illustrates how securities fraud does not explain the losses incurred by investors because the losses likely resulted from optimism towards housing prices and the consequences of their subsequent fall.

E. Economic Sense

The originate-to-distribute explanation of the Credit Crisis appears to be simplistic in light of the structuring of subprime securities.²⁶² Following the originate-to-distribute train of thought the type of crisis affecting subprime securitization would presumably affect other varieties of securitization.²⁶³ This did not happen.²⁶⁴ If the risk was successfully passed from the originator to the third-party the originator would not be forced to write down losses sustained by them in the subprime market.²⁶⁵ Accordingly,

[w]hen the majority of risk is concentrated into those bottom securities the resulting "senior-subordinate" structure dictates that the proper paradigm is not a "distribution" of risk, but a "distillation" of risk. Because of the high risk, the bottom (most risky) securities cannot typically be sold to outside investors, so they are kept on-balance sheet. Hence, the risk doesn't really leave the seller/servicer (or bank) at all.²⁶⁶

For example, in *In re New Century*, the United States District Court of the Central District of California denied defendants' motion to dismiss claims by plaintiffs about misrepresentations regarding the defendant's subprime market finan-

²⁵⁸ See Gorton, *supra* note 6, at 57-60 (describing run on SIVs).

²⁵⁹ See *id.* at 59 (stating connection between SIVs and financial sector as cause for run).

²⁶⁰ See *id.* at 82 (listing outcomes for SIVs).

²⁶¹ See *id.* at 58 ("Concurrently with the run on these vehicles, prices of subprime-related bonds began to decline. Highly levered hedged funds that held these bonds began to incur write-downs, and face margin calls. A number of hedge funds liquidated. Dealer banks began to announce write-downs.").

²⁶² See Bhardwaj, *supra* note 172, at 5 ("[The originate-to-distribute explanation] appears exceptionally simplistic in the face of detailed evidence on the securitization process.").

²⁶³ See Gorton, *supra* note 6, at 69 (noting lack of problems in other securitization processes).

²⁶⁴ See *id.*

²⁶⁵ See Bethel, *supra* note 11, at 25-26 (listing losses taken by mortgage originators).

²⁶⁶ Joseph R. Mason, *Cliff Risk and the Credit Crisis*, November 10, 2008, <http://ssrn.com/abstract=1296250> (last visited Aug. 11, 2010).

cial practices.²⁶⁷ The plaintiffs purchased defendants' common stock and alleged violations of sections 11, and 20(a) of the Securities Act of 1933 and Section 10(b) and SEC Rule 10(b)-5 of the Securities Act of 1934.²⁶⁸

The New Century plaintiffs alleged misrepresentations of New Century's (1) financial statements and internal controls; and (2) loan quality and underwriting standards.²⁶⁹ New Century's filings and registration statements stated that the firm's loan quality was, among other things, of "higher credit quality," "improved underwriting controls and appraisal review process," "a strategy [of selecting borrowers with increasing credit scores]," "strict underwriting and risk management disciplines," and "better credit quality."²⁷⁰ The New Century plaintiffs associated their economic losses with bad lending practices.²⁷¹ Although the New Century case is not between participants of subprime transactions (*e.g.*, issuers and purchasers of certificates), the case is significant because the plaintiffs were investors in the common stock of companies in the mortgage business.²⁷² As noted by the United States District Court for the Central District of California, "[t]he investments' values depend in great part on the soundness of [the Company's] core mortgage-related operations."²⁷³ The originator, New Century, lost money precisely because the company held onto the lower tranches of subprime MBS and suffered extreme losses.²⁷⁴ Consequently, the risk was not passed from the originator to third-parties. As the mortgage market collapsed lenders, *e.g.*, New Cen-

²⁶⁷ See *In re New Century*, 588 F. Supp. 2d at 1239 (C.D. Cal. 2008) ("In summary, Plaintiffs allege that Defendants, during the Class Period, misrepresented New Century's ability to repurchase defaulted loans; overvalued its residual interests in securitizations; falsely certified the adequacy of its internal controls, loan origination standards, and the quality of its loans; and failed to identify these problems in public statements, registration documents, audits, or elsewhere."). Plaintiffs to the claim comprised of persons, not including defendants, who "purchased or acquired New Century common stock, New Century Series A Cumulative Redeemable Preferred Stock ("Series A Stock"), New Century Series B Cumulative Redeemable Preferred Stock ("Series B Stock"), and/or New Century call options, or who sold New Century put options, between May 5, 2005 and March 13, 2007 (the "Class Period")." *Id.* at 1210. Defendants to the suit were "New Century officers ("Officer Defendants"), its directors ("Director Defendants"), its auditor KPMG ("KPMG"), and the underwriters of the stock offering ("Underwriter Defendants")." *Id.* Actions against New Century Financial were stayed after filed for Chapter 11 bankruptcy protection on April 22, 2008. See *id.* at 1211.

²⁶⁸ See *id.* (listing alleged securities violations). The 20(a) claim is not discussed herein.

²⁶⁹ See *id.* at 1222 (discussing section 10(b) and Rule 10(b)-5 actions).

²⁷⁰ *Id.* at 1225.

²⁷¹ See *id.* (stating allegations).

²⁷² See, *e.g.*, *In re Countrywide Financial Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1144 ("While the facts of this case are inextricably intertwined with the mortgage-backed securities ("MBS") that Countrywide sold to investment banks and other sophisticated investors, none of the actions before this Court are based on MBS purchases. Rather, the present case is brought on behalf of those who invested in Countrywide's business.").

²⁷³ *Id.*

²⁷⁴ See *In re New Century*, 588 F. Supp. 2d at 1239 (C.D. Cal. 2008) (describing business practices of New Century).

ture, were stuck with inferior loans to be sold off to third parties.²⁷⁵ Originating MBS takes time and exposes lenders to the risk of default while the originator pools the loans.²⁷⁶ The secondary market no longer had the appetite for the loans following the fall in housing prices and the originating companies were stuck with the resulting defaults.²⁷⁷

Originators of subprime MBS also retained a variety of interests in the underlying mortgages to their own detriment.²⁷⁸ In *Luminent Mortgage Capital v. Merrill Lynch*, the United States District Court for the Eastern District of Pennsylvania dismissed securities fraud claims against defendants in part because defendants retained interest in the underlying loans.²⁷⁹ Plaintiffs purchased MBS from defendants and alleged misrepresentations on the part of defendants.²⁸⁰ Plaintiffs purchased three junior classes of MBS from defendants.²⁸¹ One class was the most junior and was paid only after the senior classes.²⁸² The payments on the other two classes were limited to prepayment penalties and over collateralization, respectively.²⁸³

Plaintiffs argued that defendants made misrepresentations on the quality and nature of the underlying mortgages as well as the due diligence performed by defendants.²⁸⁴ Specifically, the plaintiffs stated that the excel spread sheet sent by defendants portraying a sampling of the underlying loans did not accurately represent the risks of the underlying loans.²⁸⁵ According to plaintiffs, the loans exhibited a higher rate of default and delinquencies than the rate

²⁷⁵ See Amiyatosh Purnanandam, *Originate-to-Distribute Model and the Subprime Mortgage Crisis* 13, (AFA 2010 Atlanta Meetings Papers, April 27, 2009), available at <http://ssrn.com/abstract=1167786> (stating problems for originating banks following collapse of market).

²⁷⁶ See *id.* (discussing timing issues related to origination).

²⁷⁷ See *id.*

²⁷⁸ See Martin, *supra* note 65, at 9-10 (listing variety of interest retained by originators in subprime MBS).

²⁷⁹ See *Luminent Mortg.*, 652 F. Supp. 2d at 578 (E.D. Pa. Aug. 20, 2009) (stating holding of case).

²⁸⁰ See *id.* (discussing nature of claim).

²⁸¹ See *id.* at 579 (describing certificates purchased by plaintiffs).

²⁸² See *id.* "Payment distributions for most of the Certificates resembled a cascade, or 'waterfall,' in which holders of the most senior class of Certificates received payments first, followed by holders of the next most senior class, and so on until holders of the most junior class of Certificates received payments." *Id.*

²⁸³ See *id.* at 579. The payments for the Class C certificates resulted from the interest left after all the senior certificates were paid and losses were accounted. See *id.* The payments for the Class P certificates resulted from the prepayment penalties on the underlying mortgage loans. See *id.*

²⁸⁴ See *id.* at 588 (stating allegations by plaintiffs).

²⁸⁵ See *id.* at 582 (alleging that spreadsheet did not meet industry standards). Plaintiffs state that, "a review of the performance of the loan portfolio over time demonstrates an unusually high rate of early payment defaults, as well as unusually high rates of delinquencies." *Id.*

represented by defendants.²⁸⁶ In accordance with the contract for the sale of the certificates, the defendants re-purchased or acquired the certificates as collateral from the plaintiffs.²⁸⁷ The court reasoned that defendants' residual interest in the certificates negated any argument of a motive to defraud.²⁸⁸ To hold otherwise would mean that defendants "intentionally defrauded Plaintiffs to their own ultimate detriment."²⁸⁹ The court, quoting the Third Circuit, stated "fraud without motive 'makes little economic sense.'" ²⁹⁰ This type of retained interest is not unique to this case, in *N.Y. State Teachers' Retirement Sys. v. Fremont General Corporation*, the court stated that "[d]epending upon market conditions, Fremont also securitized some of its subprime loan production and retained a required junior residual interest in the cash flows earned from the loans."²⁹¹ Thus, lenders kept a very significant interest in the loans originated.²⁹² Retaining these interests resulted in the originators downfall.²⁹³

Moreover, originators also provided several representations and warranties to purchasers of MBS, potentially to their detriment.²⁹⁴ In *Lone Star Fund v. Barclays Bank*, plaintiffs purchased MBS from defendants.²⁹⁵ Plaintiffs filed securities fraud claims against defendants upon learning that the underlying mortgage loans were delinquent.²⁹⁶ Defendants warranted to plaintiffs in the offering documents,

Payments Current. (i) All payments required to be made up to the Closing Date for the Mortgage Loan under the terms of the Mortgage Note, other than payment not yet 30 days delinquent, have been made and credited, (ii) no payment required under the Mortgage Loan has been 30 days or more delinquent at any time since the origination of the Mortgage Loan, and (iii) the first Monthly Payment was made with respect to the Mortgage Loan on its related Due Date or within the grace period, all in accordance with the terms of the related Mortgage Note.²⁹⁷

²⁸⁶ *See id.* .

²⁸⁷ *See id.* at 589 (noting residual interest maintained by defendants on underlying loans).

²⁸⁸ *See id.* (discussing analysis of defendants motive for fraud).

²⁸⁹ *Id.*

²⁹⁰ *Id.* (quoting *Leder v. Shinfeld* 2008 U.S. Dist. LEXIS 40925, *6 (E.D. Pa. 2008)).

²⁹¹ *New York. State Teachers'*, 2009 U.S. Dist. LEXIS 94241, n.3 (C.D. Cal. 2009).

²⁹² *See Luminent Mortg.*, 652 F. Supp. 2d at 589 (describing interest held by mortgage originator).

²⁹³ *See id.*

²⁹⁴ *See Lone Star Fund v. Barclays Bank*, 2008 WL 4449508, *8 (N.D. Tex. 2008) (listing representations and warranties provided by MBS issuer to purchaser).

²⁹⁵ *See id.* at *1 (detailing transactions between plaintiffs and defendants).

²⁹⁶ *See id.* (stating cause of action).

²⁹⁷ *Id.* at *8.

If a representation or warranty is breached, “[t]he obligations of [defendants] to cure such breach or to substitute or purchase the applicable mortgage loan will constitute the sole remedies respecting a material breach of any such representation or warranty to the holders of the [Securities], the servicer, the trustee, the depositor and any of its affiliates.”²⁹⁸ The court held that plaintiffs were bound by the remedy provided in the offering documents.²⁹⁹ This case again illustrates the retained interests originators held in MBS transactions.³⁰⁰ Defaulting loans were to be purchased back by originators at their own expense according to these representations and warranties.³⁰¹

As a result, originators faced a number of risks when securitizing mortgages.³⁰² Originators needed to house originated loans prior to securitization because the pool needed to be large enough before transfer to the underwriter.³⁰³ Some banks held onto the most senior tranches of CDOs before issuing the CDOs.³⁰⁴ This caused many firms to write-down massive losses sustained on the tranches they held for themselves.³⁰⁵ Originators also sometimes held onto the valuable servicing rights of the loans.³⁰⁶ In connection to its servicing rights, Countrywide Financial wrote-down losses totaling \$830.9 million.³⁰⁷ Additionally, originators provided representations and warranties to purchasers guaranteeing the underlying loan performance.³⁰⁸ Finally, originating banks also bought loans from other originators.³⁰⁹

The alleged incentive of the originate-to-distribute model to service as many loans as possible regardless of loan quality makes little economic sense.³¹⁰ The retained interests and risks inherent in MBS origination clearly hinder the argument that subprime market participants intended to completely separate them-

298 *Id.*

299 *See id.* at *11 (providing holding of case).

300 *See id.* at *8 (describing representations and warranties provided by MBS issuer to purchasers).

301 *See id.*

302 *See* Gorton, *supra* note 6, at 70 (describing risks facing subprime mortgage originators).

303 *See id.* (stating risk of housing mortgage loans prior to securitization).

304 *See id.* (discussing risks associated with CDO issuance).

305 *See id.* (reporting write-downs from firms who held onto senior tranches of CDOs).

306 *See id.* at 71 (detailing residual interests and servicing rights retained by firms).

307 *See id.* (reporting write-down of Countrywide Financial).

308 *See Luminent Mortg.*, 652 F. Supp. 2d at 589 (E.D. Pa. Aug. 20, 2009) (stating risks held by originator).

309 *See In re Countrywide Financial Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1144 (C.D. Cal. 2008) (“These operations include originating mortgages, purchasing mortgages from other originators, servicing mortgages, investing in mortgages, and packaging mortgages into MBS for resale.”).

310 *Cf. Luminent Mortg.*, 652 F. Supp. 2d at 589 (discounting alleged fraud in light of economic reality).

selves from default risk.³¹¹ Committing securities fraud, therefore, appears to be exactly what originators wanted to avoid because they were so open to the negative consequences of subprime mortgage default.³¹²

V. CONCLUSION

Securitizing mortgage loans enabled “mortgage lenders and mortgage bankers to access a larger reservoir of capital, to make financing available to home buyers at lower costs and to spread the flow of funds to areas of the country where capital may be scarce.”³¹³ Many commentators and plaintiffs blame the Credit Crisis on the securitization process via the originate-to-distribute model of banking. Several subprime securities fraud plaintiffs base their claims on the originate-to-distribute hypothesis of the Credit Crisis.³¹⁴ There are several obstacles, however, for subprime securities fraud plaintiffs.

Many defendants cautioned plaintiffs of the risks associated with subprime investing.³¹⁵ The Credit Crisis did not occur because of securities fraud. Housing entered an unsustainable bubble.³¹⁶ Securitization and re-securitization created a complex chain of financial instruments.³¹⁷ This complex chain caused a loss of information as to who held onto the risks associated with subprime lending.³¹⁸ When housing prices fell, market participants did not know where the risk lay and lending became nonexistent thereby causing a great devaluing in the financial sector.³¹⁹ Moreover, the securities fraud narrative makes little “economic sense” with what we know of securitization structuring. The risks associated with subprime lending were not passed from originators to investors as evidenced by the retained interests of originators and their subsequent downfall.

³¹¹ See Mason, *supra* note 266 (explaining risks retained by originating firms).

³¹² See *Luminant Mortg.*, 652 F. Supp. 2d at 589 (stating problem inherent in blaming originators when they were actually incentivized to avoid fraud).

³¹³ Securities Industry and Financial Markets Association, *Mortgage Securities: An Overview*, <http://www.investinginbonds.com/learnmore.asp?catid=11&subcatid=56&id=131> (last visited Aug. 11, 2010).

³¹⁴ See, e.g., *Atlas*, 556 F.Supp.2d at 1149 (S.D.Cal. 2008) (blaming misrepresentations regarding companies' core business for stock inflation and subsequent devaluation); *New York State Teachers'*, 2009 U.S. Dist. LEXIS 94241, *3-4 (C.D. Cal. 2009) (stating basis for complaint).

³¹⁵ See, e.g., *Plumbers' Union*, 658 F. Supp. 2d at 307 (D.Mass. 2009) (stating fusillade of cautionary statements provided to plaintiffs).

³¹⁶ See TAYLOR, *supra* note 4, at 1 (“In the recent crisis we had a housing boom and bust, which in turn led to financial turmoil in the United States and other countries.”).

³¹⁷ See Gorton, *supra* note 6, at 3 (summarizing loss of information and complexity problems in securitization process).

³¹⁸ See Greenspan, *supra* note 257 (discussing risks in market and loss information for market participants).

³¹⁹ See Gorton, *supra* note 6, at 76 (stating importance and consequences of housing price decline in Credit Crisis).

Therefore, the losses realized by plaintiffs are not the result of securities fraud through originate-to-distribute; rather the losses are consequence of an economic black swan.