Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis

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Top MBS Underwriters, 2007

Writedowns ($MM) Related to Subprime, 8/20/08

#1 Lehman Brothers: $5,200
#2 Bear Stearns & Co., Inc.: $5,000
#3 Morgan Stanley: $14,400
#4 JPMorgan: $14,500
#5 Credit Suisse: $10,400
#6 Banc of America Securities LLC: $10,600
#7 Deutsche Bank AG: $14,600
#8 Royal Bank of Scotland Group: $22,200
#9 Merrill Lynch: $61,800
#10 Goldman Sachs & Co.: $23,000
#11 Citigroup: $30,000
#12 UBS: $35,200

Legal and Economic Issues...

» 135 class action lawsuits
» 43 defendants
» % of suits whose class period began in...

Legal and Economic Issues...
Three Basic Principles in U.S. Securities Law

1. “No fraud by hindsight”
2. “Truth on the market”
3. Losses arising from market-wide failures do not give rise to recoverable damages...
Principle 1

“No Fraud by Hindsight”
"No fraud by hindsight"

» Quality of loan collateral
Underwriting Standards in Subprime Home-Purchase Loans, 2001–2006

Source: Katie War, obtained from the International Monetary Fund via http://www.imf.org/external/pubs/ft/finance/2007/03/WarK.htm.pdf

Legal and Economic Issues...
Underwriting Standards in Subprime Home-Purchase Loans, 2001–2006


Legal and Economic Issues...
## Mortgage Loan Innovation

**Mortgage Products**

- Fixed-Rate Mortgages
- FHA Mortgages
- VA Mortgages
- Adjustable Rate Mortgages
- Option (Flexible Payment) ARMs
- Balloon Mortgages
- Biweekly, Bimonthly, and Weekly Payment Mortgages
- Shared Appreciation Mortgages
- Dual Index Mortgages
- Wrap-Around Mortgages
- Interest-Only Mortgages
- Graduated Payment Mortgages
- Simple Interest Mortgages
- 80/20 Mortgages
Loan Types in Subprime Home-Purchase Loans, 2001–2006


Legal and Economic Issues...
Loan Types in Subprime Home-Purchase Loans, 2001–2006


Legal and Economic Issues...
"No fraud by hindsight"

- Quality of loan collateral
- Characteristics of the loan origination process
Compensation to Participants

Loan Closing

Broker
0.5% - 3%

Lender
0.5% - 2.5%

Appraiser Fee

MBS/CDO Issuance

Underwriter
0.25% - 1.5%

Ratings Service Fee

Due Diligence Service Fee
“No fraud by hindsight”

» Quality of loan collateral
» Characteristics of the loan origination process
» Structure of securities
MBS and CMO Market, 1996-2007

Data Source: AprilMkt.com.

Legal and Economic Issues...
MBS and CMO Market, 1996-2007

Data Source: AllReal.com

Legal and Economic Issues...
“No fraud by hindsight”

» Quality of loan collateral
» Characteristics of the loan origination process
» Structure of securities
» Quality of collateral disclosure
» Structure of Bank Funding
Quality of Collateral Disclosure Over Time
Principle 2

“Truth on the Market”
Principle 3

Losses arising from market-wide failures do not give rise to recoverable damages...
Losses Arising from Market-Wide Failures Do Not Give Rise to Recoverable Damages

» Can losses be decomposed into losses resulting from market information failures vs. firm-specific factors?
Losses Arising from Market-Wide Failures Do Not Give Rise to Recoverable Damages

» Can losses be decomposed into losses resulting from market information failures vs. firm-specific factors?
» To what extent are losses correlated because of market factors?
Losses Arising from Market-Wide Failures Do Not Give Rise to Recoverable Damages

» Can losses be decomposed into losses resulting from market information failures vs. firm-specific factors?

» To what extent are losses correlated because of market factors?

» To what extent were write-offs a result of firm-specific exposures vs. market events?
### 2006 Value at Risk vs. Writedowns (8/20/08)

<table>
<thead>
<tr>
<th>Firms</th>
<th>2006 VaR ($MM)</th>
<th>Writedowns ($MM) 8/20/08</th>
<th>Writedowns/VaR</th>
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<tbody>
<tr>
<td>Bank of America</td>
<td>$41</td>
<td>$21,200</td>
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<tr>
<td>Bear Stearns</td>
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<td>Lehman Brothers</td>
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<tr>
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Conclusions