

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

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*Presentation at Brookings-Tokyo Club-Wharton Conference — October 16, 2008*

## Top MBS Underwriters, 2007

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

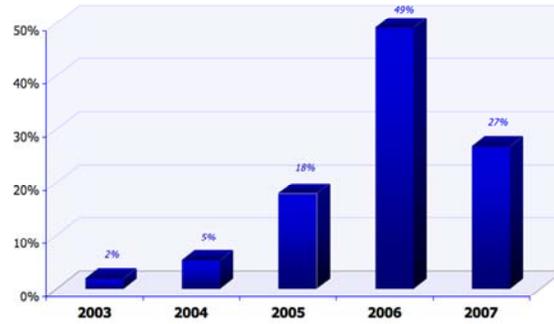


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## Securities Class Action Lawsuits, 2/8/2007-2/18/2008

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



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## 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...

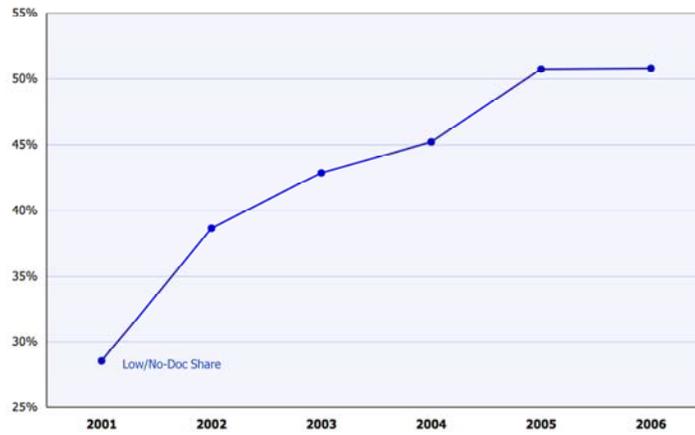
# Principle 1

“No Fraud by Hindsight”

## **“No fraud by hindsight”**

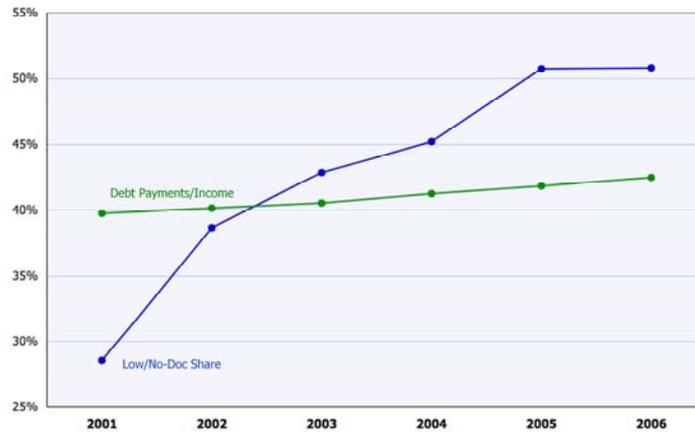
» Quality of loan collateral

## Underwriting Standards in Subprime Home-Purchase Loans, 2001–2006



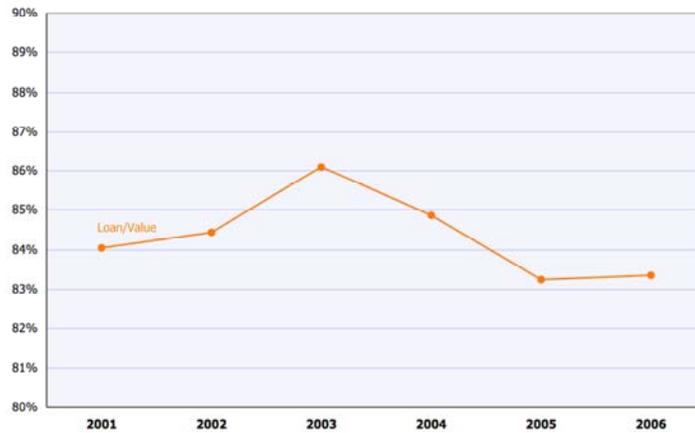
Source: Freddie Mac, obtained from the International Monetary Fund via <http://www.imf.org/external/pubs/ft/fmu/eng/2007/charts.pdf>.

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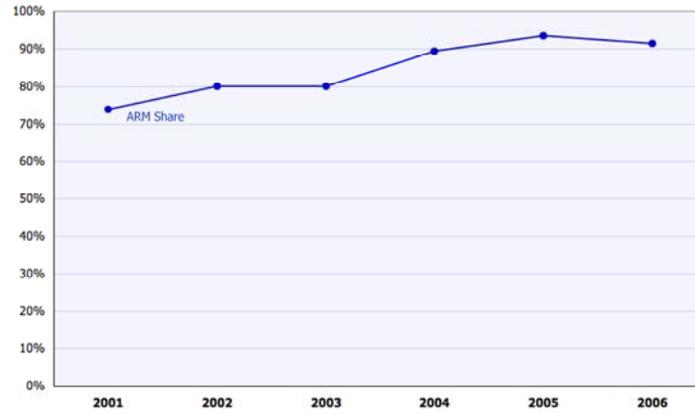


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# Mortgage Loan Innovation

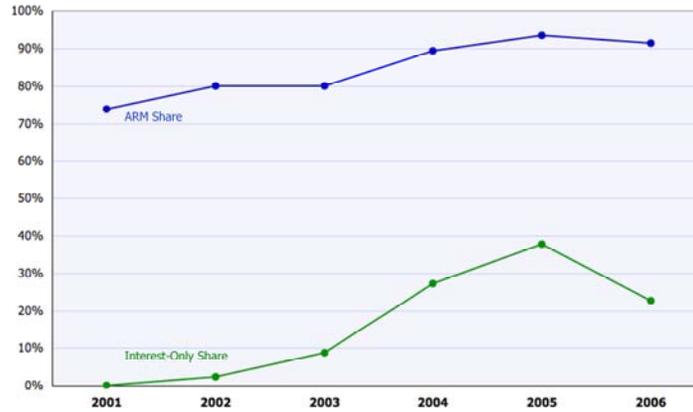
<b>Mortgage Products</b>
<i>Fixed-Rate Mortgages</i>
<i>FHA Mortgages</i>
<i>VA Mortgages</i>
<i>Adjustable Rate Mortgages</i>
<i>Option (Flexible Payment) ARMs</i>
<i>Balloon Mortgages</i>
<i>Biweekly, Bimonthly, and Weekly Payment Mortgages</i>
<i>Shared Appreciation Mortgages</i>
<i>Dual Index Mortgages</i>
<i>Wrap-Around Mortgages</i>
<i>Interest-Only Mortgages</i>
<i>Graduated Payment Mortgages</i>
<i>Simple Interest Mortgages</i>
<i>80/20 Mortgages</i>

## Loan Types in Subprime Home-Purchase Loans, 2001–2006



Source: Freddie Mac, obtained from the International Monetary Fund via <http://www.imf.org/external/pubs/ft/fmu/eng/2007/charts.pdf>.

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## **“No fraud by hindsight”**

- » Quality of loan collateral
- » Characteristics of the loan origination process

# Compensation to Participants

## Loan Closing



## MBS/CDO Issuance



## **“No fraud by hindsight”**

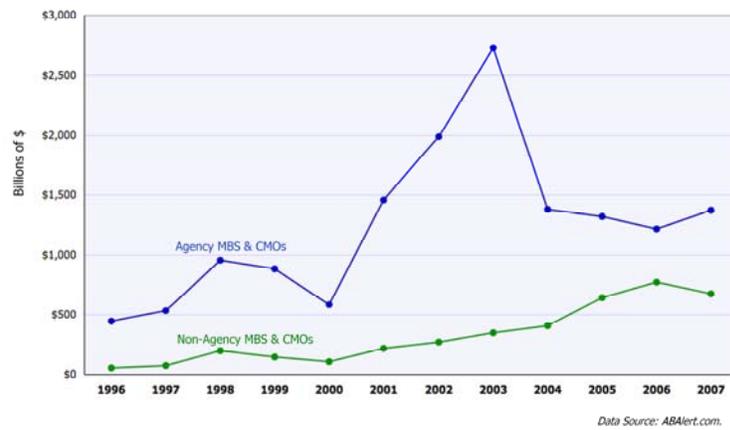
- » Quality of loan collateral
- » Characteristics of the loan origination process
- » Structure of securities

## MBS and CMO Market, 1996-2007

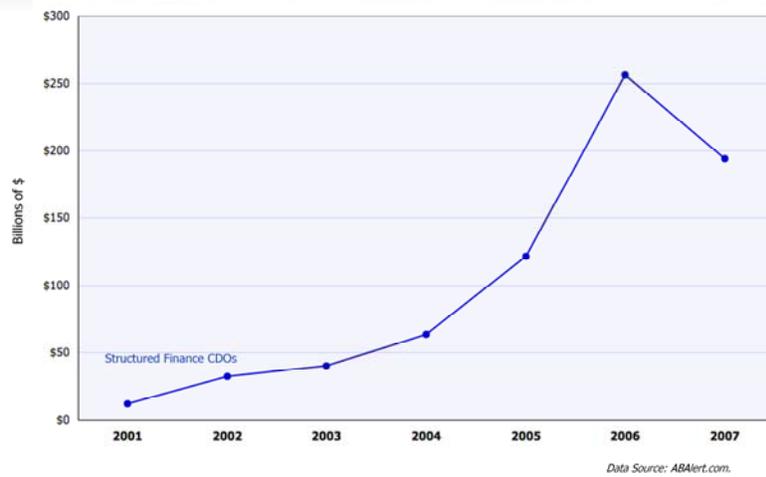


Data Source: ABAlert.com.

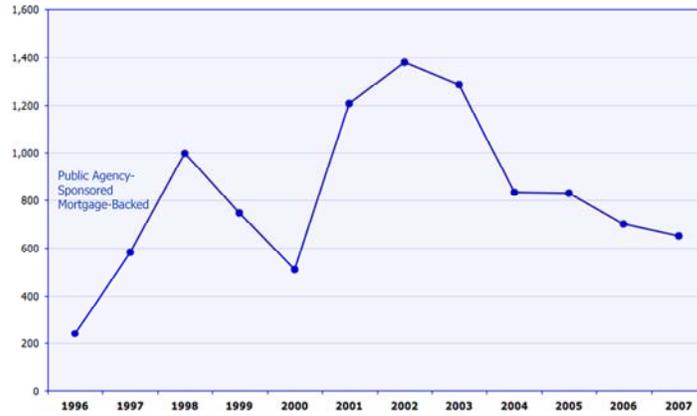
## MBS and CMO Market, 1996-2007



## CDO Market, 2001-2007



## Average MBS Deal Size, 1997–2007



Data Source: SDC Platinum.

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## **“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

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# 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?

# Decomposing the Spread



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## 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)

Firms	2006 VaR (\$MM)	Writedowns (\$MM) 8/20/08	Writedowns/VaR
Bank of America	\$41	\$21,200	513
Bear Stearns	29	3,200	111
Citigroup	106	55,100	520
Credit Suisse	73	10,400	143
Deutsche Bank	101	10,600	104
Goldman Sachs	119	3,800	32
JP Morgan	104	14,300	138
Lehman Brothers	54	8,200	152
Merrill Lynch	52	51,800	996
Morgan Stanley	89	14,400	162
UBS	133	44,200	332

# Conclusions