

Expanding Subprime Mortgage Crisis Increases Litigation Risks

Author:

George S. Oldfield

Phone:

+1.202.955.5050

Email:

George.Oldfield@brattle.com

The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world.

We have offices in Cambridge, Massachusetts; San Francisco; Washington, DC; Brussels; and London.

Contact us:

www.brattle.com

office@brattle.com



INTRODUCTION

The credit quality problems that first appeared in subprime mortgages last year have begun to spread into other loan categories as we move further into 2008. Prime mortgages, home equity credit lines, vehicle loans, and credit card receivables are all showing increased rates of non-performance. Originators, servicers, guarantors, and securitizers of these loans face increased exposure to legal actions by disgruntled investors because these loans are major sources of collateral for securitized deals held by various types of investment funds.

This piece is a follow up to *The Brattle Group's* Finance Newsletter from Fall 2007 titled "Subprime Mortgage Problems: What to Look For and Where to Look".

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1. SPREADING CREDIT PROBLEMS

Spreading credit problems are evident in the increasing rate of occurrence of troubled loans. By the end of December 2007, about 2.2 percent of prime mortgages were at least 60 days past due. This was the highest percent of troubled prime loans observed since the Mortgage Bankers Association began tracking prime mortgage problem loans in 1998. In 2006, the 60-day delinquency rate was only 1.5 percent for prime mortgages. In the subprime category, over one-fifth of mortgage loans were past due or in foreclosure.

Vehicle loans, home equity lines of credit, credit card paper, and other types of consumer borrowing are starting to display trends similar to the credit problems that first emerged with subprime mortgages. Commercial real estate loans are also being affected, although they are not directly tied to consumer credit problems. For example, Macklowe Properties was served a notice of default last month on a structured deal involving over \$7 billion in loans on Manhattan office buildings.

Since commercial mortgages wind up in institutional portfolios directly or indirectly (through syndications, CLO's, and REIT securities and loans), complex securities litigation alleging malfeasance by syndicators, securitizers, and investment advisors concerning disclosure, due diligence, and prudence can be expected.

2. INSURANCE PROBLEMS

As prime residential mortgage problems continue to grow, Fannie Mae and Freddie Mac could be adversely affected through their guarantor programs for mortgage pass-throughs. Late in February 2008, Fannie Mae announced a \$3.6 billion loss for the last three months of 2007. Freddie Mac reported a \$2.5 billion loss for the same period.

Private insurance companies are struggling even now: mono-line underwriters Ambac, CIFG, MBIA, and FGIC are under credit review with negative im-

plications by major rating agencies, although MBIA's triple-A rating was recently affirmed by Moody's and S&P. Multi-line companies like AIG are reporting problems as well.

If the mono-line companies are significantly downgraded (FGIC has already been downgraded once and Ambac has been downgraded by Fitch), it could lead to an avalanche of down-grades for tranches of securitized loans and derivatives for which these companies act as guarantors. The result would be unanticipated markdowns on investments and forced sales by fiduciary investors, which is likely to spawn litigation and create pressure to reorganize in order to isolate risks.

For instance, one proposal for the mono-line bond insurers is to split themselves into two companies: one to guarantee muni's, the other to guarantee more complex instruments and derivatives. This proposal recalls the "good bank, bad bank" structures of the 1990's thrift crisis, most of which were not successful without substantial amounts of new capital to enhance the structure. Even with new capital, disputes over the assignment of existing liabilities and reserves are unavoidable.



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Another potential problem area involves over-the-counter insurance products like credit default swaps. Back-office problems in dealer firms are preventing the timely assignments of appropriate counterparties in traded instruments. Some assigned insurance providers are being contested by their counterparties due to credit quality concerns.

As the hedge funds that are very active in this market begin to experience difficulties, failures to perform by assigned counterparties will become quite contentious. A number of mortgage-based funds have closed recently and are liquidating.

3. LITIGATION HIGHLIGHTS

Spreading credit problems will lead to new areas of litigation. Several hundred private actions related to alleged problems with subprime mortgages have been initiated in the last year, mostly in the form of shareholder suits. Recently initiated government investigations will likely lead to new avenues of litigation as well.

- ◆ *Nearly 300 subprime-related federal cases were filed in 2007*
- ◆ *The FBI and SEC are currently investigating about three dozen companies involved in subprime origination and securitization*
- ◆ *State authorities in New York, Massachusetts, California, Florida, and Connecticut are investigating a variety of subprime-related issues*

In the future, allegations about disclosure deficiencies on exception loans, lax underwriting standards, loan substitution problems, and loan servicing quality are probable areas for investor litigation. This litigation will likely roll back through the securitization chain, from investors to dealers and from dealers to servicers, originators, and insurers. Several recently filed actions illustrate the types of complex litigation that will arise from the current credit crisis:

◆ *Margin calls and collateral sales in the securitization process: Luminent Mortgage Capital v. HSBC Securities; Attentus Management Group v. UBS Securities*

◆ *Investment management and appropriate investments: MetroPCS Communications v. Merrill Lynch*

These suits involve disputes about the financing, warehousing, valuations, and risks of complicated fixed income instruments.

The Brattle Group's Experience in Subprime Mortgage Litigation

Principals and academic affiliates of *The Brattle Group* have extensive experience in subprime mortgage securitization, structured bond transactions, due diligence standards, ERISA investment requirements, and SEC Regulation AB.

Our experts possess firsthand knowledge of trading desk practices, the securitization process, and pricing conventions in fixed income markets. We have conducted forensic finance and accounting studies of failed transactions, and we are often called upon to provide expert testimony in litigation on these matters.

Our experience includes work in class actions, derivatives, executive compensation, stock options, asset-backed securities, breach of fiduciary duty, valuation, and bankruptcy.

The Brattle Group works on behalf of commercial banks, savings and loans, insurance companies, broker-dealers, investment banks, pension funds, mutual funds, hedge funds, and finance companies.

CONCLUSION

The credit quality problems that first affected the subprime mortgage industry are unlikely to disappear any time soon. In fact, given the pace of litigation and workouts in the 1990's thrift crisis (also mortgage-based), resolution of the current credit crunch is likely years away. Tracking through a troubled transaction requires industry knowledge, accounting expertise, and detailed financial analysis. *The Brattle Group* can provide these skills to parties affected by deals gone bad.

The Brattle Group's Experts in Subprime Mortgage Matters

Dr. Lynda S. Borucki
Principal

Dr. Borucki, head of the firm's finance practice, is a financial economist who specializes in the application of corporate finance, economics, and accounting in securities and commercial litigation matters. Her work includes analysis of damages, valuation, and regulation in a wide variety of industries including damages for banks arising out of the savings and loan crisis.



Dr. George S. Oldfield
Principal

Dr. Oldfield has experience as an SEC enforcement officer, a dealer in the securitization business, and a banker in "good bank, bad bank" structuring. He has written widely about securitization, fixed income investments, and financial institution risk management in leading academic journals.



Dr. Bente Villadsen
Principal

Dr. Villadsen specializes in accounting disclosure, accounting principles and their application, and cost of capital. She has worked and testified on accounting issues related to commercial litigation, class action lawsuits, and financial disclosure.

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