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• The Credit Crisis and Subprime Litigation: How Fraud without Motive ‘Makes Little Economic Sense’

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

ARTICLE

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I. INTRODUCTION

O N 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

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Credit Crisis.\textsuperscript{2} The Credit Crisis\textsuperscript{3} began with a complex chain of events.\textsuperscript{4} Falling housing prices and subprime mortgages are generally considered the starting blocks of the Crisis.\textsuperscript{5} Subprime mortgage origination accounted for $1.2 trillion in 2005 and 2006.\textsuperscript{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.\textsuperscript{7} These deteriorating loans sent shockwaves through the financial system because the loans were held by several financial market participants.\textsuperscript{8} The credit market subsequently halted as lenders became wary of borrower credit.\textsuperscript{9}

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

\textsuperscript{2} See id. (stating market conditions).
\textsuperscript{5} See id. at 1 (describing falling housing prices role in Credit Crisis).
\textsuperscript{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.").
\textsuperscript{9} See \textit{Taylor}, supra note 4, at 16 (describing credit freeze).
\textsuperscript{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.\textsuperscript{14} The risks associated with the loans were allegedly not disclosed to investors.\textsuperscript{15} Therefore, according to this narrative, originators committed securities fraud to their investors by not disclosing.\textsuperscript{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.

\section{Securitization: Financial Innovation or Financial Frankenstein?}

\textbf{A. The Subprime Mortgage Market and Housing Prices}

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


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

\textsuperscript{16} See id. (providing plaintiffs’ argument that lender committed securities fraud).

\textsuperscript{17} See Gorton, supra note 6, at 8 (reporting growth of subprime market).


\textsuperscript{19} See id. (discussing differences between prime and nonprime borrowers).

\textsuperscript{20} See id.

\textsuperscript{21} See Gorton, supra note 6, at 13 (describing standard prime mortgage operation).

\textsuperscript{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. Alt-A borrowers generally have good credit scores and are considered between subprime and prime borrowers in terms of risk. For conveniences purposes I will refer to Alt-A and subprime borrowers 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, repossessions, or charge-offs 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.

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

Subprime lending is based upon the assumption that potential home equity is the greatest form of wealth for a low-income household. "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." 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)." Subprime mortgages start with an initial fixed-rate ending with the "reset date," (usually after 2 or 3 years) whereupon the borrower is incentivized...
to refinance the mortgage otherwise triggering a much higher rate.\textsuperscript{30} The overwhelming majority of subprime mortgages include prepayment penalties to discourage prepayment.\textsuperscript{31} The combination of the hybrid adjustable-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.\textsuperscript{32} Subprime mortgages work by "forcing" the borrower to refinance after two or three years.\textsuperscript{33} "The lender is essentially long [on] the house, exposing the lender to house prices more sensitively than conventional mortgages."\textsuperscript{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)."\textsuperscript{35} Without house appreciation, a great number of subprime mortgages default.\textsuperscript{36} Subprime mortgage loans are more sensitive to housing prices than prime mortgage loans because of the forced refinancing.\textsuperscript{37} Thus, the lender and borrower are attempting to benefit from price appreciation in the home over a short time horizon.\textsuperscript{38}

\textsuperscript{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.

\textsuperscript{31} See Gorton, supra note 6, at 13 (detailing importance of prepayment penalties).

\textsuperscript{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 Schuemmann 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.

\textsuperscript{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.

\textsuperscript{34} Id. at 17 (explaining rationale for subprime mortgage origination).

\textsuperscript{35} Id. at 3.

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

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

\textsuperscript{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"). Securitization is important because it can transform previously untradeable assets into tradable asset-backed securities ("ABS"). 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.

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

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39 See Richard J. Rosen, The role of securitization in mortgage lending, Chicago Fed Letter No. 244, November 2007, available at www.bus.ucf.edu/ssmith/MtgSecu.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.


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-ec9b-4752-ba8f-0c14af44884 (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. The SPE pools and holds onto the mortgages and issues securities or bonds to investors. 48

MBS are tranched 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. 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. 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 tranched to be thick enough to absorb collateral losses to ensure that the senior

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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 130.

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


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.\textsuperscript{66} 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.\textsuperscript{63}

Eighty percent of subprime mortgage origination in 2005 and 2006 resulted in securitization.\textsuperscript{65} There are four financial and economic reasons for securitizing mortgages and other assets.\textsuperscript{64} First, securitization enhances the mortgage loans’ credit rating making them easier to sell.\textsuperscript{65} Investors do not have the time or resources to inspect the financial condition of the companies’ assets.\textsuperscript{66} Thus, credit ratings help firms assess the level of risk associated with specific securities.\textsuperscript{67} Second, selling the underlying assets removes them from the firm’s balance sheet.\textsuperscript{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-

\textsuperscript{61} Id. at 24.

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

\textsuperscript{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).


\textsuperscript{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.


\textsuperscript{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).

\textsuperscript{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.” Schvarcz, supra note 71, at 143.
thetically easier to calculate when spread.\textsuperscript{69} Finally, mortgages can be split into tranches through securitization.\textsuperscript{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.\textsuperscript{71}

C. Subprime Mortgage Backed Securities

Subprime securitization is different from ordinary MBS securitization because of the greater credit risk associated with subprime borrowers.\textsuperscript{72} In response to the credit risk posed, the subprime securitization process features many structural innovations.\textsuperscript{73} First, subprime MBS issuers can use excess spread.\textsuperscript{74} Excess spread is the difference between the interest paid from the subprime mortgages and the interest issued on the MBS.\textsuperscript{75} The excess spread creates overcollateralization to be used in conjunction with the senior/sub structure to further enhance the senior tranche’s credit.\textsuperscript{76} The excess spread is used by the issuer to protect investors against losses in the underlying mortgages.\textsuperscript{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-

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{71} See id. (listing benefits of securitization process for investors).

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

\textsuperscript{73} See id. at 21 (detailing design features of subprime MBS).

\textsuperscript{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.

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

\textsuperscript{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.

\textit{Id.}

\textsuperscript{77} See ASHCRAFT, supra note 32, at 31 (stating purpose of excess spread in MBS).
Third, issuers include performance triggers which transfer principal payments immediately from the subordinated bonds to the senior bonds. Performance triggers trigger when there are losses or delinquencies in the underlying mortgages and a specified target level of collateral is not reached. 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.

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.” Issuers, therefore, enter into interest rate swap agreements with third-parties. The issuer agrees to pay the third-party a fixed rate while the third-party pays the issuer an adjustable rate. Furthermore, issuers provided representations and warranties guaranteeing loan performance. 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.

### 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.”

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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.


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).\textsuperscript{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].”\textsuperscript{89} For example, a bank that lends millions to a company may wish to hedge their risk against the company defaulting on the loan.\textsuperscript{90} The bank enters a CDS with a third-party.\textsuperscript{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.\textsuperscript{92} CDS account for a large part of the credit derivatives market.\textsuperscript{93} “The primary purpose of credit derivatives is to enable the efficient transfer and repackaging of credit risk.”\textsuperscript{94} Firms use CDS to “bet on a debt issuer’s bankruptcy, default, or restructuring.”\textsuperscript{95} Thus, CDS allow banks and other market participants to hedge their risks against borrowers.\textsuperscript{96} CDS lower the potential costs for a lender of a borrower’s default.\textsuperscript{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.\textsuperscript{98}

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

\textsuperscript{88} See id. at 1021
\textsuperscript{90} See Partnoy, supra note 87, at 1021-22 (providing example of CDS).
\textsuperscript{91} See id.
\textsuperscript{92} See id. (explaining CDS operation).
\textsuperscript{93} See O’Kane, supra note 89, at 3 (noting importance of CDS in chain of financial instruments).
\textsuperscript{94} Id.
\textsuperscript{95} Partnoy, supra note 87, at 1021.
\textsuperscript{96} See id. at 1023 (listing benefits of CDS to companies).
\textsuperscript{97} See id. at 1023-24 (discussing CDS benefits to lenders).
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. A "synthetic" CDO is composed of credit derivatives. A synthetic CDO, consisting of several CDS with third parties, creates "synthetic exposure to the outstanding debt" of several companies. Cash flow, synthetic and hybrid CDOs were further purchased and pooled into additional CDOs, known as CDO\(^2\) or CDO-squared. No data exists explaining the extent of CDOs’ exposure to subprime risk. CDS contracts may have also resulted in the amplification in the amount of CDO exposure. The exposure problem is compounded by the lack of transparency in the derivatives market. 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.

Companies purchased CDOs through off-balance sheet Structured Investment Vehicles (“SIV”). "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,

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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.
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 CDO\(^2\)) 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]." Thus, SIVs leveraged themselves by borrowing short and purchasing long assets. SIVs were purchasers of subprime CDO tranches and were exposed to a great deal of subprime risk. During the Credit Crisis, the majority of SIVs were put back onto their firm’s balance sheets, restructured, or defaulted.

Information on subprime risk became available to the market in the form of the ABX.HE indices ("ABX"). The ABX was created by Markit Partners in January of 2006. The ABX tracks CDS referencing twenty equally-weighted MBS transactions. Investors use the ABX to trade subprime CDS. Thus, the ABX allowed investors to trade on the risk of subprime default through CDS. The ABX serves as a barometer of investor confidence in subprime mortgages. "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]." Thus, the ABX played a key role in disseminating information regarding investor confidence in subprime risk. In 2007 investors ran for protection from subprime risk by purchasing CDS on the ABX causing ABX prices to dramatically fall.

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. Congress promulgated the acts "to insure honest securities markets and thereby promote investor confidence after the market crash of

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112 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).
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).
116. 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.

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." 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. 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 tight of the circumstance under which they were made, not misleading."

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. Some commentators also blame weaknesses in the originate-to-distribute model for the Credit Crisis. The originate-to-distribute model differs

129 See 15 U.S.C.S. § 77k(a) (imposing civil liability for false or misleading statements made in registration statement).
from the traditional lend and hold approach of banking where the bank lent to the borrower and held onto the loan until full payment.\textsuperscript{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.\textsuperscript{134} This allows the originator to hand off the risk of repayment to the third party.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{137} Consequently, originators became focused on the fees from origination volume instead of the underlying loan quality.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{140} When housing prices soured the inferior loans defaulted in mass.\textsuperscript{141} The proliferation of the inferior loans into the financial system through securitization magnified the damage to the economy.\textsuperscript{142} Former
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.”

**B. A ‘Fusillade’ of Cautionary Statements**

Many subprime plaintiffs blame their economic losses on poor lending practices. Subprime plaintiffs organize their securities fraud claims based upon alleged misrepresentations companies made about their lending procedures and other loan related practices. Cautionary statements in prospectuses and registrations statements, however, put potential plaintiffs on notice of the risks associated with the subprime mortgage industry. 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”). 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. Nomura’s certificates were significantly backed by Alt-A loans and the certificates suffered severe losses following the collapse of the subprime market. On July 17, 2007, Moody’s Investors Services announced that it might downgrade the certificates’ ratings. This action resulted in significant losses on the certificates and Nomura closing its U.S. mortgage loan business.

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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).


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 $50 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.\textsuperscript{152} Plaintiffs argued that Nomura’s underwriting and loan originating standards were focused on volume instead of quality.\textsuperscript{153} Defendants’ prospectuses stated that prospective borrowers were required to complete an application so defendants could determine the credit risk of the borrower.\textsuperscript{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.’”\textsuperscript{155} Plaintiffs argued that these statements were false when made by Nomura because Nomura did not filter out potentially risky borrowers using such methods.\textsuperscript{156} The court, however, stated that statements in Nomura’s prospectuses warned the plaintiffs of lower than average credit standards.\textsuperscript{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.\textsuperscript{158}

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

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

\textsuperscript{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).

\textit{Id.}

\textsuperscript{155} Id.

\textsuperscript{156} See id. at 305 (stating plaintiffs’ argument that statements in prospectuses and registration statements were false and misrepresented).

\textsuperscript{157} See id. (quoting language from prospectuses demonstrating relaxed credit standards).

\textsuperscript{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

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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. Investors were provided “numerous warnings” and were told of “originator’s ‘soft’ underwriting practices.” Therefore, subprime MBS originators did not commit securities fraud to investors because the investors were given such warnings.

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. Some economists argue that lending standards radically deteriorated due to the originate-to-distribute banking model. According to these commentators, lenders originated as many loans as possible because the risk was subsequently sold to third-parties. One study connected the proportion of default rates to the proportion of company’s originate-to-distribute banking. 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. 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.


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. 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. Borrowers with a FICO score slightly above 620 are considered liquid and likely to be securitized. 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. The FICO score ordinarily measures a borrowers’ credit risk. The study argues that if the FICO score is higher yet defaults with greater frequency the loan must be a consequence of relaxed screening. Therefore, relaxed lending standards created a higher rate of default.

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. Many plaintiffs argue that underwriting standards started to relax and decline after 2004 as evidenced by mortgage foreclosures and delinquencies beginning in 2005. In one study, researchers demonstrated that underwriting standards from 1998-2007 did not decline, specifically after 2004. 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. According to their research, “the underwriting process attempted to adjust riskier borrower characteristics with lower loan-to-value ratios (and higher mortgage rates).”

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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 Purmanandam, 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.”).
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.
Although lending standards declined in some areas, it improved in others.\textsuperscript{190} Documentation of borrowers may have lowered, whereas FICO scores increased.\textsuperscript{199} Moreover, using counterfactual analyses, the study argues that had loans underwritten in 2005 been underwritten in 2001 or 2002, the loans would have performed \textit{significantly better} than loans actually originated in 2001 or 2002 had housing prices behaved similarly.\textsuperscript{192} Overall, the study states that lending standards did not drastically weaken in the subprime market from 1998-2004.\textsuperscript{193} Another study notes that borrower characteristics improved while documentation may have fallen.\textsuperscript{194}

Several other economists point to real estate price depreciation as the greatest factor in the Credit Crisis, not relaxed lending standards.\textsuperscript{195} Lending standard deviations, if correct, may have been immaterial to the losses suffered on MBS.\textsuperscript{196} The real problem was housing prices.\textsuperscript{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.\textsuperscript{198} Consequently, securities fraud would not explain the losses suffered by investors.

\textsuperscript{189} See id. at 22 (finding no dramatic changes in lending standards post-2004).
\textsuperscript{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.
\textsuperscript{191} See id. at 3 (providing examples of increasing risk factors and decreasing risk factors).
\textsuperscript{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.”).
\textsuperscript{193} See id. at 3 (highlighting conclusion of study).
\textsuperscript{196} See id.
\textsuperscript{197} See Mayer, supra note 195 (discussing falling housing prices impact on economy).
\textsuperscript{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.

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\(^{199}\) 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).


\(^{201}\) 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.frbarlanta.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. Because no one knew where the assets lay it became a guessing game as to who had exposed themselves to default risk. Therefore, complexity in financial transactions and lacking transparency created compounded asymmetric and lack of information problems.

2. The Housing Bubble and Monetary Policy

Historically, asset-price increases are “encouraged” by relaxed monetary policies. Housing prices are hyper sensitive to interest rate changes because housing is incredibly leveraged. 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. Beginning in 2001, the Federal Reserve lowered short-term interest rates well below the recommended Taylor Rule for an unusually extended amount of time. Taylor argues that housing prices became inflated because of the unusually low short-term interest rates. This monetary policy made it attractive for consumers to borrow as credit became easier to obtain. It became very rational for consumers to purchase homes because the lending was in essence subsidized by the government. Consumers purchased secondary homes and home speculation became a thriving business. 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).
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).
twenty-five percent during the housing boom. Moreover, during the period of low short-term interest rates the number of ARMs increased to cover one third of the total mortgages issued. The ARM attracted borrowers with teaser rates. 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. From 1997 to 2006, housing prices rose 40% above their traditional long run level. As housing prices increased, so did housing price inflation. Demand for housing subsequently increased to historic levels.

During the housing market boom subprime mortgage origination worked very well. Subprime loans originated between 2001 and 2005 performed better than loans originated in 2000. Subprime loan delinquency and foreclosure rates declined over the same time period because of the increase in housing prices. Moreover, participants in the subprime market considered a decline in housing prices highly unlikely. Many participants believed that price appreciation would continue, even if only at the traditional long run average. The worst case scenario, according to participants, was stagnate growth in prices. One participant gave a decline of five percent in housing prices an overall probability of five percent.

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216 See id. (indicating growth in ARM market during relaxed monetary policy).
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. Bernanke states that "only a small portion of the increase in house prices [...] can be attributed to the stance of U.S. monetary policy." According to Bernanke, subprime lending and the global savings glut are responsible for the housing bubble. As noted above, subprime lenders believed that housing prices could only go up. As subprime lending expanded this view became a self-fulfilling prophecy. Additionally, Bernanke argues that the global savings glut increased housing prices. 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." 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.

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

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.").
234 Bernanke, supra note 236, at 18.
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).
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 pay to pass the triggers required for refinancing.\textsuperscript{245} With rising housing prices, the MBS passed its triggers and refinanced; however, when housing prices fell the MBS did not refinance and lost the credit enhancement for which it was designed.\textsuperscript{246} The difference between the two MBS illustrates the sensitivity MBS have towards house prices.\textsuperscript{247} Without house price appreciation the MBS failed to trigger and become delinquent.\textsuperscript{248} Many mortgage originators and investors took heavy losses on the subsequent credit downgrades.\textsuperscript{249}

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

The housing market entered an unsustainable bubble.\textsuperscript{254} When housing prices fell so did the value of financial instruments connected to housing.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{257} This loss of in-

\begin{itemize}
\item 245 See id. at 34 (comparing 2005 and 2006 vintages of Ameriquest Mortgage Securities, Inc.).
\item 246 See id. (noting failure of MBS when housing prices failed to rise).
\item 247 See id.
\item 248 See id.
\item 250 See Gorton, supra note 6, at 54 (stating role of ABX in disseminating information to market on subprime risk).
\item 251 See id. at 57 (describing ABX decline and subsequent conclusions).
\item 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.”).
\item 253 See id. (discussing fall of ABX when firms hedged their subprime risk).
\item 254 See TAYLOR, supra note 4, at 1 (blaming financial crisis on loose monetary policy).
\item 255 See Gorton, supra note 6, at 61 (discussing connection between home values and security values).
\item 256 See id. (summarizing loss of information and asymmetric information problem).
\end{itemize}
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).
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 1220. 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.

tury, were stuck with inferior loans to be sold off to third parties.\textsuperscript{275} Originating MBS takes time and exposes lenders to the risk of default while the originator pools the loans.\textsuperscript{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.\textsuperscript{277}

Originators of subprime MBS also retained a variety of interests in the underlying mortgages to their own detriment.\textsuperscript{278} In \textit{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.\textsuperscript{279} Plaintiffs purchased MBS from defendants and alleged misrepresentations on the part of defendants.\textsuperscript{280} Plaintiffs purchased three junior classes of MBS from defendants.\textsuperscript{281} One class was the most junior and was paid only after the senior classes.\textsuperscript{282} The payments on the other two classes were limited to prepayment penalties and over collateralization, respectively.\textsuperscript{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.\textsuperscript{284} Specifically, the plaintiffs stated that the excel spreadsheet sent by defendants portraying a sampling of the underlying loans did not accurately represent the risks of the underlying loans.\textsuperscript{285} According to plaintiffs, the loans exhibited a higher rate of default and delinquencies than the rate

\begin{verbatim}
\textsuperscript{276} See id. (discussing timing issues related to origination).
\textsuperscript{277} See id.
\textsuperscript{278} See Martin, supra note 65, at 9-10 (listing variety of interest retained by originators in subprime MBS).
\textsuperscript{280} See id. (discussing nature of claim).
\textsuperscript{281} See id. at 579 (describing certificates purchased by plaintiffs).
\textsuperscript{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.
\textsuperscript{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.
\textsuperscript{284} See id. at 588 (stating allegations by plaintiffs).
\textsuperscript{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.
\end{verbatim}
represented by defendants.\textsuperscript{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.\textsuperscript{287} The court reasoned that defendants’ residual interest in the certificates negated any argument of a motive to defraud.\textsuperscript{288} To hold otherwise would mean that defendants “‘intentionally defrauded Plaintiffs to their own ultimate detriment.”\textsuperscript{289} The court, quoting the Third Circuit, stated “fraud without motive ‘makes little economic sense.’”\textsuperscript{290} This type of retained interest is not unique to this case, in \textit{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.”\textsuperscript{291} Thus, lenders kept a very significant interest in the loans originated.\textsuperscript{292} Retaining these interests resulted in the originators downfall.\textsuperscript{293}

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

\textit{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.\textsuperscript{297}

\textsuperscript{286} See id.
\textsuperscript{287} See id. at 589 (noting residual interest maintained by defendants on underlying loans).
\textsuperscript{288} See id. (discussing analysis of defendants motive for fraud).
\textsuperscript{289} Id.
\textsuperscript{290} Id. (quoting Leder v. Shinfeld 2008 U.S. Dist. LEXIS 40925, *6 (E.D. Pa. 2008)).
\textsuperscript{291} \textit{New York State Teachers’}, 2009 U.S. Dist. LEXIS 94241, n.3 (C.D. Cal. 2009).
\textsuperscript{292} See Luminent Mortg., 652 F. Supp. 2d at 589 (describing interest held by mortgage originator).
\textsuperscript{293} See id.
\textsuperscript{295} See id. at *1 (detailing transactions between plaintiffs and defendants).
\textsuperscript{296} See id. (stating cause of action).
\textsuperscript{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.” The court held that plaintiffs were bound by the remedy provided in the offering documents. This case again illustrates the retained interests originators held in MBS transactions. Defaulting loans were to be purchased back by originators at their own expense according to these representations and warranties.

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

The alleged incentive of the originate-to-distribute model to service as many loans as possible regardless of loan quality makes little economic sense. 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).
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.”).
selves from default risk. 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.

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.” 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. There are several obstacles, however, for subprime securities fraud plaintiffs.

Many defendants cautioned plaintiffs of the risks associated with subprime investing. The Credit Crisis did not occur because of securities fraud. Housing entered an unsustainable bubble. Securitization and re-securitization created a complex chain of financial instruments. This complex chain caused a loss of information as to who held onto the risks associated with subprime lending. 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. 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 Luminent Mortg., 652 F. Supp. 2d at 589 (stating problem inherent in blaming originators when they were actually incentivized to avoid fraud).
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.