LITIGATIONS, DAMAGES AND SOLUTIONS IN RESIDENTIAL MORTGAGE-BACKED SECURITIES

Jomadar, Dinesh

9 March 2009

LITIGATIONS, DAMAGES AND SOLUTIONS

IN

RESIDENTIAL MORTGAGE-BACKED SECURITIES

Contents

Abstract

Mortgage-backed securities (MBS) are debt obligations whose cash flows are backed by the principal and interest payments of pools of mortgage loans, most commonly on residential property (Riddiough, 2001). Lenders establish underwriting guidelines, evaluate prospective homeowners' credit, and make loans. Having done so, lenders generally hold only a fraction of the loans they make in their own portfolios. Most are sold to the secondary market, where they are pooled and become the underlying assets for residential mortgage-backed securities. Individuals with strong credit qualify for traditional mortgages, whereas those with weak credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies qualify for subprime loans (Hayre, 2001). Securitization is the financial technology that integrates the market for residential mortgages with the capital markets. Investment banks take pools of home loans, carve up the cash flows from those receivables, and convert the cash flows into bonds that are secured by the mortgages. The bonds are variously known as residential mortgage-backed securities (R-MBS) or asset-backed securities (ABS).

Introduction

Residential Mortgage-Backed Securities (R-MBS) is a debt instrument, which, pursuant to its terms, entitles the holder to receive as its primary source of repayment the cash flows derived from an underlying pool of residential mortgages, which serves as collateral for the security. The mortgage loans are purchased from a seller, usually the originator or mortgagee, and are pooled with loans having similar characteristics. The buyer is a special purpose vehicle (SPV) formed to issue mortgage-backed securities. When such securities are issued, the mortgage loans underlying the security are assigned to a trustee. The Trustee takes possession of the mortgage loans and any additional credit enhancements supporting the related securities on behalf of the investors. The creation of a mortgage occurs in the primary mortgage market, while the purchase and resale of mortgages takes place in the so-called secondary mortgage market. The secondary mortgage market serves the purpose of replenishing the supply of funds available to create additional mortgages. Securing a credit rating for a RMBS significantly enhances its liquidity as well as its potential sales price.

The UK mortgage market is dominated by variable-rate mortgages. Although the mortgage rate is adjusted to reflect current interest rates, variable rate mortgages carry prepayment risk; lenders take time to adjust their mortgage rates to changes in market rates so re-financing opportunities exist in the market. Kau, Keenan, Muller and Epperson (1993) point out that in order to correctly value adjustable rate mortgages and adjustable rate mortgage-backed securities both, default and prepayment risks must be taken into account. The risk of prepayment faced by the investor in mortgage-backed securities is the risk of the securities being called at any time due to the investors prepaying their mortgages (Fabozzi, 1992). The issuing prospectus of sterling mortgage-backed securities clearly state this risk by pointing out that the notes are partially redeemable at any coupon payment date by the amount of prepayment in the pool since the last payment date. The disadvantage for the holder of the note is that if prepayment

occurs when interest rates are falling, the holder will have to reinvest the proceeds at a lower rate, so there is reinvestment risk (Cummings, 1997). Also, the life of the notes is uncertain.

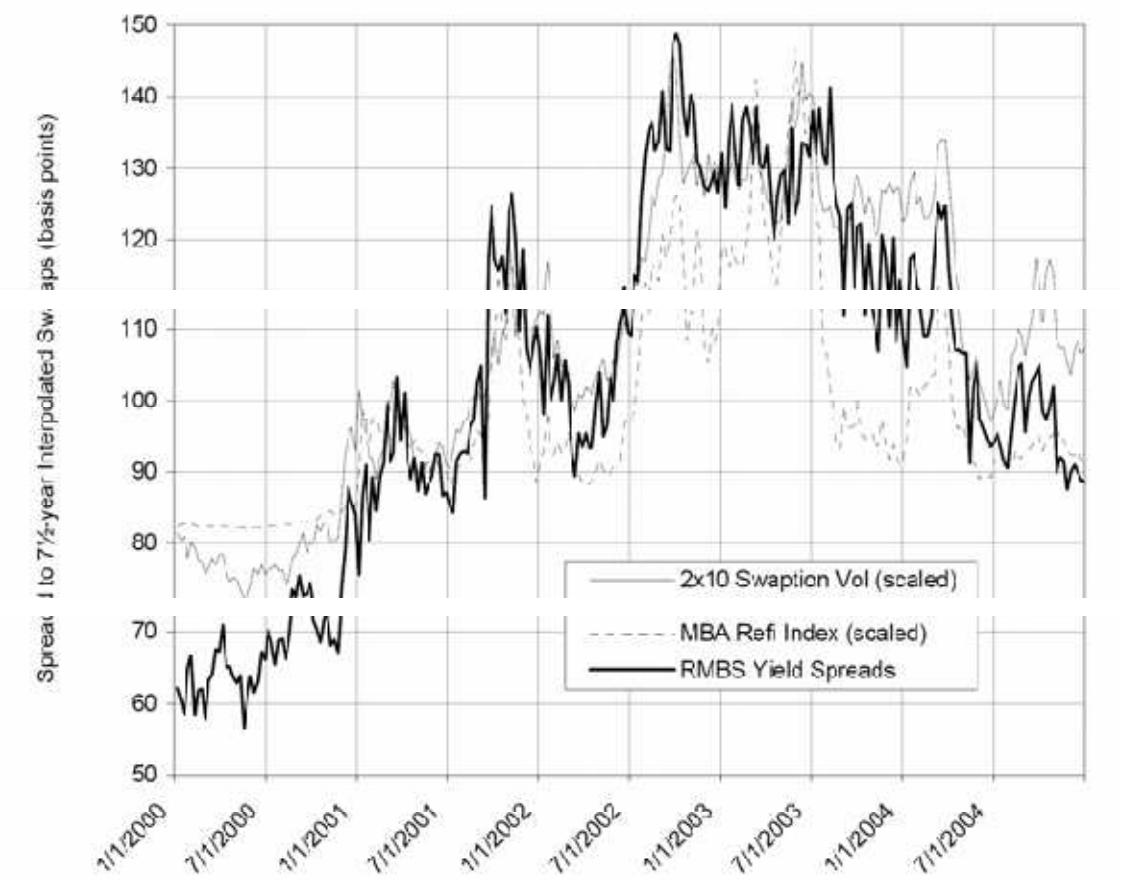
Conventional wisdom holds that market volatility or market risk has declined. For risk that remains, markets have reduced the price for taking on that risk. Boudoukh, Richardson, Stanton, and Whitelaw (1995) show that even after doing as good a job as possible hedging mortgage-backed securities using Treasury securities, a sizeable fraction of the original volatility remains. This suggests that there may be one or more omitted variables.[1] A leading candidate for such an omitted variable is the level of house prices. Not only do housing prices affect the level of default activity, but a low house price also affects the borrower's ability to qualify for a new loan, and hence may also affect refinancing behaviour.[2]

Figure 1, below illustrates the conventional view as it related to mortgage markets. Since 2003, swaption volatility has decreased substantially, along with the Mortgage Bankers Association Refinancing cost index and residential mortgage-backed security (R-MBS) yield spreads over LIBOR. Such circumstances have reduced mortgage costs to homebuyers and set the stage for the "new financial markets," that are thought to more efficiently value and price risk. Of course, risk does not go away. It can be diversified in portfolios, but diversification works to only offset risk. Hence, if risk is priced lower, that pricing must reflect either an increased appetite for fully-disclosed risk or the lack of disclosure of risk for the same risk appetite.

[1] An alternative potential explanation is that everything *is* driven only by interest rates, but that mortgages cannot be hedged using Treasury securities alone due to the presence of unspanned stochastic volatility Collin-Dufresne and Goldstein (2001). However Boudoukh (1995) show that interest rate volatility does not help to explain much of the residual volatility of MBS prices.

[2] A number of prior empirical studies have documented the importance of home equity on the propensity to re-finance Becketti and Morris (1990), Monsen (1992), Caplin, Freeman, and Tracy (1993). Stein (1995), Archer, Ling, and McGill (1996), Mayer and Genesove (1997), Mattey and Wallace (1998), and Mattey and Wallace (2001) also emphasize the importance of housing prices as a determinant of regional level household mobility.

Figure 1: Residential R-MBS Yield Spreads, MBS REFI Index, and Swaption Volatility



Source: Nomura, Structured Finance Trends – Yield Spreads, Credit Support, and Collateral Performance

The above figure illustrates many of the key changes to residential mortgage origination and servicing standards that have occurred over the past two decades. Those changes have ultimately resulted in a wider range of risk among the types of financial instruments call mortgages.

Non-agency ("private label") securities, which are not guaranteed by the government or the government-sponsored enterprises, now account for the majority of residential mortgage-backed securities issued. When changes to origination and servicing occur unpredictably over time or across issuers, thereby affecting the cash flows of some unknown number of mortgages, R-MBS become more difficult to value. Hence, changes

in origination and servicing practices, along with the existing complexity of R-MBS, results in greater opacity in the residential mortgage-backed securities market.

Risks of Investing in Residential Mortgage-Backed Securities

The investor in mortgage-backed securities faces the risks related to investing in the underlying mortgages. These risks include the options embedded in any mortgage contract (Arnold, 2002). As a result, a mortgage-backed security is a complex financial instrument. A mortgage borrower has two options: the option to default, i.e. to "put" the property back to the lender at an exercise price equal to the value of the mortgage; and the option to prepay, i.e. to "call" the mortgage from the lender at an exercise price equal to the outstanding principal. These options can be exercised at any time. However, in some cases, prepayment during the first year carries a penalty of between 1 to 3 months of interest rate. However borrowers prepay for a myriad of other non-financial reasons: sale of the property, divorce, or a new job in another location (Glaeser, 1997).

Figure 2: Risk Grading in the Mortgage Industry

Summary of Fitch Mortgage Credit Grade Matrix

	A+	A	A–	B	B–	C	C–	D
Mortgage History (Last 12 Months)	0 x 30	0 x 30	1 x 30	2 x 30	3 x 30	4 x 30 1 x 60	5 x 30 2 x 60	6 x 30 1 x 90
Foreclosures/NOD	None	None	None in last five years	None in last four years	None in last three years	None in last two years	None in the last year	None pending
Installment Debt (Last 24 Months)	0 x 30	0 x 30	1 x 30	1 x 60	2 x 60	1 x 90	2 x 90	> 2 x 90
Revolving Debt (Last 24 Months)	1 x 30	1 x 30	2 x 30	Maximum: 60	Maximum: 60	Maximum: 90	Maximum: 90	> 90
Bankruptcy	None	None	Discharged with good credit past five years	Discharged with good credit past four years	Discharged with good credit past three years	Discharged with good credit past two years	Discharged with good credit past year	Within one year
Judgments/Chargeoffs	None	Minor; under $500 allowed	None over $500 in last two years	None over $1,000 in last two years	None over $1,000 in the last year	None over $1,000 in last year	Allowed with explanation	Allowed with explanation
Debt-to-Income Ratio	< 80% LTV: 33%/38%; > 80% LTV: 28%/33%	40%	45%	50%	50%	55%	55%	60%

NOD – Notice of default. LTV – Loan-to-value ratio.

Source: Fitch IBCA, Rating U.S. Residential Subprime Mortgage Securities, Jul. 18, 2001.

Figure 2 illustrates the increased gradation of risk among mortgage borrowers. The additional grades of risk arise from the willingness to underwrite mortgages for more risky borrowers, making riskier loans to more typical borrowers. Both practices increase the total amount of risk to be sold in the marketplace. However, increased grading of risk induced increased complexity, and therefore increased opacity. Risk that is more difficult to see, by virtue of complexity, is risk just the same. There are plenty of reasons to believe that the amount of risk in the marketplace has increased while opacity has made it seem otherwise. The traditional approach to pricing mortgage and mortgage-backed securities has been to construct a theoretical model to value the options embedded in the mortgage: this requires modelling the dynamic behaviour of interest rates and house prices, incorporating prepayment and default options in the price of the mortgage-backed securities (Corcoran, 1989). Building societies, the major mortgage lenders, and the Council of Mortgage Lenders (a body that groups all the authorised mortgage lenders) rarely disclose information. Data on default only appears semi-annually, building societies publish quarterly repayment data, but the high level of aggregation of the figures reduces their usefulness. Empirical validation of any model of prepayment and default is therefore limited.

Legal Issues

Needless to say, that parties adversely affected by the losses created by the decline in the value of his residential mortgage-backed securities is likely to bring legal actions seeking to recover some of these losses. An example of the potential for extensive litigation arising out of losses is the situation of Luminent Mortgage Capital, Inc. Luminent Mortgage Capital is currently suing Merrill Lynch (and various Merrill Lynch subsidiaries and affiliates) for alleged misrepresentations with respect to the sale of junior MBS tranches as well as HSBC Holdings for allegedly improperly placing too low a value on nine subprime mortgages that a subsidiary of Luminent Mortgage Capital had put up as collateral. Luminent Mortgage Capital, in turn, has five Rule 10b-5 class action suits filed against it for false statements as well as a counter-suit by HSBC Holdings for breach of contract.

False or Misleading Statement

R-MBS documentation must reflect the underlying analysis of the cash flows and ensure that the parties are required to take the requisite actions under local law to convey the collateral, perfect a security interest in it, collect and distribute the cash flows in accordance with the financial model and exercise the bondholder's rights in the event of a default. R-MBS documentation establishes the contractual relationship between the issuer, the investor and all other parties; sets out specific terms of the issue; states any covenants that restrict the parties and provides information about the issuer, including its financial status, to enable a fair price to be set for the issue and to enable investors to make an informed decision about its purchase; provides guidelines for the distribution of the cash flows; perfects a security interest in the collateral; and provides a mechanism for liquidation of collateral in the event of a default. One possible claim is a false or misleading statement in the registration statement, giving rise to Section 11 liability. The

issuer of the security, the SPV, underwriters, and auditors will all be subject to potential Section 11 liability (with the latter two groups having due-diligence defences). With respect to other communications made during the registered offering process, misleading statements can give rise to Section 12(a) (2) liability. And, of course, such misstatements would be subject to Rule 10b-5 liability, but such a cause of action would have to survive the difficult hurdle of demonstrating responsibility. There are four misleading disclosures in the registration statement or offering communications for registered residential mortgage-backed securities, all relating in some way to the underwriting quality of the underlying mortgages themselves that could potentially be pursued such as:

- outright fraud with respect to the documentation surrounding the mortgage origination rendering statements made in the offering process false;

- lack of adequate disclosure of underwriting standards for the underlying mortgages;

- the extent to which exceptions were made to whatever the underwriting standards were; and

- the pricing of the various R-MBS tranches.

The presence of these disclosure issues in the registration statement, including fraud in the mortgage origination, will prove problematic for an SPV as there is no Section 11 due-diligence defence for issuers. With respect to all four disclosure issues, the role of the due-diligence firms looms as a potentially critical litigation issue in the actions being brought against various actors in the structured finance arena. The information provided to these parties by the due-diligence firms on the quality of the underlying mortgages is very likely to be the subject of extensive litigation for a number of reasons. First, the provision (and even the availability) of due-diligence information to the investment banks (Global Integrated Bank) acting as the underwriter for the R-MBS will arguably affect the availability of a Section 11 due-diligence defence with respect to material

misstatements in the MBS registration statement. The Plaintiff in this regard is likely to point to the *In re Worldcom, Inc. Securities Litigation*, 346 F.Supp. 2d 628 (S.D.N.Y. 2004) decision, where the court concluded that defendants had not established a due diligence defence due to "red flags" that should have put the Section 11 defendants on notice that *Worldcom's* accounting was inaccurate.[3] Second, the provision of information on the underwriting quality of the mortgages will also arguably speak to the available of a "reasonable care" defence (the defendants did not know and in the exercise of reasonable care could not have know) with respect to any Section 12(a)(2) suits brought by plaintiff. Third, such information might be used in actions such as breach of contract and negligent misrepresentation claim.

Finally, there are a number of possible state causes of action, including breach of contract, fraud, and negligent misrepresentation that might be brought by plaintiff. In short, it is quite likely that the plaintiff, in attempting to establish liability for various disclosure deficiencies, will attempt to rely upon information that is uncovered by the on going investigations in terms of what was actually known by the due-diligence firms concerning mortgage underwriting quality and the extent to which that information was shared with the investment banks.

[3] The key issue here will be what constitutes a "red flag" necessitating further investigation before a due-diligence defence will be viable.

Due Diligence

The real importance of the role of the due-diligence firm is likely to lie not in the context of litigation brought by the R-MBS purchaser, but rather in the large Rule 10b-5 class actions that have been filed against the investment bank. Plaintiff will undoubtedly argue that the information that was given to the investment bank in their capacity as sponsor of SPVs issuing R-MBS, one of the main hurdles in bringing a Rule 10b-5 action; that is, Global Integrated Bank, it will be claimed, knew that the R-MBS securities and the CDO interests that they held on their own book were worth significantly less than what they were reporting to the markets. Moreover, the same line of attack will be employed to argue that the "contingent losses" faced by the investment bank as a result of potentially having to bring SPV assets onto their own book. In the context of this litigation filed against Global Integrated Bank, the claim will be that the investment bank and mortgage originators breached their duty of care and loyalty by purchasing imprudent investments.

The distinction between ex ante expectations and ex post losses

The basic distinction between *ex ante* expectations and *ex post* losses, a distinction fundamental to finance theory will go to the core of many of the alleged disclosure deficiencies with respect to the investment banks' disclosures to their security holders. A failure to provide detailed disclosures concerning the implications of an event that was unexpected by most investment bankers, as evidenced by the huge losses many of these investment banks themselves suffered, will likely prove an important stumbling block for plaintiffs.

The decision in *Olkey v. Hyperion 1999 Term Trust*, 98 F.3d 2 (2d Cir. 1996) is instructive on this point. In this decision the Court considered the claim by investors in a closed-end fund that held R-MBS that there was liability based on Section 11 and 12(a)(2) of the Securities Act of 1933, and Rule 10b-5 of the Exchange Act. The investors claimed, among other things, that there was a misrepresentation in the prospectuses marketing the fund, because it failed to disclose the risky nature of the underlying R-MBS portfolio and, furthermore, that there was a failure to disclose the size of the potential losses if there was an adverse move in interest rates. Needless to say, the purchasers in this case suffered substantial losses.[4] In rejecting these arguments, it was noted that the plaintiffs "claim that another set of investment choices should have been made, based upon a different conception of what interest rates would do. . . . This is only to say in hindsight that the managers of those [alternative] funds turned out to be more skillful in their predictions." In other words, the presence of disclosure failures (and the materiality thereof) must be assessed in light of what was knowable at the time of the disclosure, even if *ex post* substantial losses have occurred.[5] A number of pieces of evidence will speak to what was foreseeable at different points in time, some of which have already been raised, such as the changing nature of the R-MBS market in recent years.

[4] Re K-Tel Int'l, Inc. Securities Litigation, 300 F.3d 881, 893 (8th Cir. 2002).
[5] Ford Motor Company Securities Litigation, 381 F.3d 563 (6th Cir. 2004)

One way to consider this issue is to look at Global Integrated Bank reported value at risk (VaR) estimates, a widely used measure by investment banks to measure the risk inherent in their financial positions, immediately before the losses. Did these estimates predict, even in a rough way, the size of the subsequent write downs or even which firms were most exposed in a situation where the credit markets substantially tightened? In short, Mr Joyner will have to provide a basis to establish that there was misleading material disclosures made beyond merely noting that there was extensive economic loses.

Undisclosed information already known by the market does not give rise to recoverable damages

Another important issue that will be germane to many of the securities claims being filed is not only what did the issuer (or other parties being sued) reasonable know *ex ante,* but what did the market know and when did it know. With respect to macroeconomic issues, such as the current or future state of the economy, interest rates or the national housing market, it is quite implausible to believe that the SPVs or the investment bank (Global Investment Bank) sponsoring and underwriting the R-MBS had any special knowledge concerning these matters that was not already know by the market (Hendershott, 1989). In a situation where the market is as informed as a defendant, whether it be an SPV or some other participant in the structured finance market, as to a particular issue, then the "truth on the market" doctrine in securities law will provide an opportunity for defendants to argue that any misrepresentation concerning that issue was not material and, hence, not actionable.[6]

If this information was not known (or even knowable) by Global Integrated Bank then the issue of "loss causation" will become important. "Loss causation" is the necessary connection between a material misstatement and economic losses and must be established by him in a Rule 10b-5 action and is a defence in Section 11 and Section 12(a) (2) actions. The Supreme Court, in its seminal decision in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336, 352-53 (2005), explained that losses due to "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" will not be recoverable as a result of the loss causation requirement. The Global Integrated Bank here will likely argue that a changed "economic circumstance" and "new industry-specific" factor was the unexpected nationwide decline in the fortunes of the housing market. Losses occurring as a result of this are therefore non-recoverable as they were not caused by any disclosure deficiency, even assuming that there was one.[7] The

[6] Ganino v. Citizen Utilities Co., 228 F.3d 154, 167 (2000).
[7] Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007)

question will be the extent to which the information allegedly held by the investment bank would have changed market expectations if the market had learned the information. As always, the burden of establishing that such a change in market expectations would have occurred, and hence the disclosed information is arguably "material" is placed on Mr Late-Joyner.

With respect to claims that there was inadequate disclosure of potential exposure to off balance sheet losses, the "truth on the market" doctrine will once again be potentially relevant. Even assuming an obligation to disclose such information under the applicable accounting rules, the question will remain whether such non-disclosure was material or, rather, was the market already aware of potential off-balance sheet exposures. Details of the off-balance sheet arrangements, information relating to off-balance sheet exposures could have reached market participants, such as hedge funds, that could trade on that information in the course of buying and selling the investment banks' stock (thereby ensuring that the investment banks' stock price reflected this information). The plaintiff need to so allege to establish reliance on a class-wide basis, but it does raise a successful "truth on the market" argument as to the non-materiality of the off-balance sheet exposures.

Disclosure deficiencies

There is another distinction that is likely to prove important in litigations that is worth bearing in mind. This distinction is between disclosure issues with respect to the quality of the underlying mortgages (or Mortgage-backed securities in the case of Collaterized debt Obligations) and disclosure issues with respect to which parties were exposed to the risk of these assets falling in value. Investment banks, SPVs, mortgage originators or, for that matter, Global Investment Bank simply have no legal duty to disclose where the risk in the system lies. Indeed, it would be literally impossible for such disclosures to take place, as no single entity has such information. In practical terms, an institution transfers its assets to a legally isolated and bankruptcy remote "special purpose entity" (SPV). The assets, structured properly, are allowed to be removed from the balance sheet of the selling company it then records a gain in accordance with accounting standards (Skarabot, 2002). To be effective for the selling company the sale must comply with domestic and international accounting standards. Auditors will not sign off on moving of assets "off of the balance sheet" for accounting purposes without a legal opinion recognizing the securitization as a "true sale". That is to say, simply, that the assets have moved beyond the control of the seller (Higgins, 2004). This serves several purposes, especially for financial institutions. Among them, it generally allows the firm to have less deposits to fund loan activity, in most periods this market financing will be less costly to larger institutions than other funding, and it generally allows them to hold less regulatory capital than they would have to if they held all of the credit risk.

Accounting Issues

The typical Rule 10b-5 class action complaint against Global Integrated Bank alleges that the bank did not adequately disclose and reserve for its potential liability for losses experienced by off balance sheet entities. Obviously allegations of improper disclosure of losses that might occur due to off-balance sheet exposures will turn on the applicable accounting rules. In the context of off-balance sheet entities exposed that resulted in losses for investment banks (as well as mortgage originators), much of the discussion to date has focused on whether there was a "true sale," as defined in Statement of Financial Accounting Standard No. 140, *Accounting for Transfers and Extinguishments of Liabilities* (FASB 140), of mortgages by the investment bank (or the mortgage originator) to the SPV issuing the MBS. This is of considerable interest given that if there was a "true sale" then the asset need not remain on the balance sheet of the transferor upon sale. The importance of FASB 46(R) in the context of litigation lies primarily in the fact that many CDOs with subprime exposure are subject to FASB 46(R) given their structure.

The FASB 46(R) analysis reflects the basic distinctions between *ex ante* expectations versus *ex post* losses and information held by GIB versus information held by the market as a whole that were emphasized earlier. FASB 49 46(R) requires calculation of which entities, if any, are subject to a majority of the off-balance sheet's *expected* losses and returns, not realized losses and returns. Furthermore, FASB 46(R) refers to FASB Concept Statement Number 7, *Using Cash Flow Information and Present Value in Accounting Measurements* when describing how the probabilities of future events should be calculated.

This Concept Statement explains that, “The use of an entity’s own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that Global Integrated Bank would use different assumption. If such data exists, the entity must not adjust its assumptions to incorporate that market information.” In other words, expected losses and returns must be based, to the extent possible, on the market’s perception of the probability of future events, rather than the individual entity’s determination. One arguably possible indication of the market’s assessment of the probability of future losses is whether or not the CDO tranche enjoys an investment-grade rating (Oldfield, 2000).

Employee Retirement Income Security Litigation

There has already been a number of lawsuits filed arising out of the mortgage crisis under the Employee Retirement Income Security Act, 1974 (ERISA). ERISA suits have been filed, among others, against Citigroup, MBIA, Merrill Lynch, Morgan Stanley, and State Street. The ERISA litigation represents an important component of the litigation as it provides plaintiffs with two important advantages. First, plaintiffs need not establish responsibility as is the case under Rule 10b-5. Rather, liability is based on a breach by a defendant of a fiduciary duty. Second, at least pre-*Dura Pharmaceuticals*, the measure of damages resulting from a breach of a fiduciary obligation has tended to be quite generous, at least as reflected by the terms on which suits are settled.

The fiduciary breach

Virtually all complaints filed against the investment banks and mortgage originators to date claim that the company executives and administrators who oversaw the retirement plans knew, or should have known, that the company was facing substantial losses and, hence, should have disclosed this information to plan participants. Several interesting issues arise with respect to the plaintiff claim, besides the obvious issue once again of whether the mortgage crisis was foreseeable. One issue looming in the background is the extent to which court will be willing to transform ERISA into a third general securities disclosure statute complementing (or substituting) for the detailed disclosure regimes established in the Securities Act of 1933 and the Exchange Act of 1934. An announcement by ERISA fiduciary that a firm was facing substantial losses due to subprime exposure would have resulted in a drop in the value of the stock held by Mr Joyner. If such a disclosure would not have resulted in a stock market reaction, it is difficult to see how there could be a duty to disclose the information in the first place as it would not be material. But this logic has an interesting resulting from such an ERISA violation. The failure to disclose the adverse information by the ERISA fiduciary did not cause the losses suffered by plaintiffs with respect to the securities he held at the time the breach of the duty to disclose, but rather merely delayed it.

Employee Retirement Income Security Litigation Damages

Plaintiffs bringing ERISA actions can be argued, relying on the Second Circuit's 1985 opinion in *Bierwirth v. Donovan*, 754 F.2d 1049, that damages should be calculated based on the best performing fund available in the plan. In times of market declines, such a fund might well be a money market fund. This approach can effectively render the ERISA fiduciary an insurer against general declines in the stock market. The ERISA statute itself merely states that the ERISA fiduciary shall "make good to such plan any losses to the plan resulting from each such breach . . ." 29 U.S.C. 1109 (2000). The Supreme Court's decision in 2005 in *Dura Pharmaceuticals* explained that losses due to market and industry-wide developments will not result in damages if such damages are not caused by actionable misconduct (in *Dura Pharmaceuticals* the misconduct was actionable under Rule 10b-5) by the defendant. Applying the same reasoning to ERISA damages, parties could argue that market and industry wide declines are not the "*result [ ]*" of a breach of fiduciary duty. Such an argument, given the important implications it has for the extent of the damages available under ERISA, will be hotly contested. The issues involved in resolving such a debate are quite involved, including consideration of the proper interpretation of the *Bierwirth* opinion, the continued validity of *Bierwirth* in light of *Dura Pharmaceuticals*, and the notion of "causation" in the common law of trust that has been used by courts in the course of interpreting the ERISA statute.

The rating agencies

The challenge facing plaintiffs here are two-fold:

- specifying the precise meaning of "excessively high"; and

- why "excessively high" ratings, so defined, "inflated" the stock price of the rating agencies to the detriment of their security holders.

A rating arguably has no meaning without reference to the criteria that generated it, which was publicly known and could be independently assessed by third parties. The source of the fraud is therefore difficult to locate. The rating agency gets paid for providing a rating and not for the success of the offering (Hendershott, 1989). RMBS, as part of a static capital structure, funding a static investment strategy composed exclusively of fixed income assets, and trading thinly over the-counter with few market price signals, require dynamic ratings in order to adequately reflect risk. The main point is therefore that, in the case of R-MBS, bond ratings are being used for something they were not initially intended and often sold on the basis of a fundamental misunderstanding of diversification. In summary, R-MBS are complex securities that are difficult to value. R-MBS are built on the backs of pools of mortgages, which themselves are complex and difficult to value. Furthermore, fundamental changes to underwriting and servicing standards are not easily identifiable in the inherent complexity of mortgages and R-MBS, posing risk to funding for socially and economically important consumer mortgage originations.

Conclusion

The risk premium on mortgage-backed securities is influenced by contractual features and market variables that increase the risks associated with investing in these types of securities. The longer the life of the securities the higher the premium demanded by the investors (Walsh, 1995). One of the benefits of securitization finance is the relationship between the risk profile of the issuer and the investor: since the assets backing the issue are isolated, the risk and return of the securities depends on the risk and return of the assets, and not on the risk and return of the issuer (Kolari, 1998). UK mortgage-backed securities market: the price of the securities largely reflects factors influencing the underlying assets. The residential mortgage industry crisis is one of the foremost economic issues facing the UK today. This crisis is not solely an economic phenomenon but a legal one as well. It is widely believed that the substantial decrease in the value of asset-backed securities faced by investment banks and other purchasers that held previously rated investment grade CDOs with subprime exposure (Lucas, 2006), as well as junior or mezzanine tranches of R-MBS will generate substantial, perhaps unprecedented, levels of litigation. Alternatively, this litigation will serve to highlight where the market may have underestimated certain risks, failed to anticipate particular circumstances, or identified those links in the mortgage chain that may have been weak. This is a distinction that plaintiffs will undoubtedly have to struggle with.

Bibliography and References

Archer, W. R., D. C. Ling, and G. A. McGill, 1996, The effect of income and collateral constraints on residential mortgage terminations, Regional Science and Urban Economics 26, 235–261.

Arnold, Alvin, Real Estate Investor's Desk book, West, 2002.

Becketti, S., and C. S. Morris, 1990, The prepayment experience of FNMA mortgage-backed securities, Working paper, New York University Salomon Center.

Boudoukh, J., M. Richardson, R. Stanton, and R. F. Whitelaw, 1995, A new strategy for dynamically hedging mortgage-backed securities, Journal of Derivat*ives* 2, 60–77.

Bronchick, William and Dahlstrom, Robert, Flipping Properties, Dearborn Trade, 2001.

Caplin, A., C. Freeman, and J. Tracy, 1993, Collateral damage: How refinancing constraints exacerbate regional recessions, Working Paper 4531, NBER.

Collin-Dufresne, P., and R. S. Goldstein, 2001, Do credit spreads reflect stationary leverage ratios?, Journal of Finance 56, 1929–1957.

Corcoran, P. J., Commercial Mortgages: Measuring Risk and Return, Journal of Portfolio Management, 69–74, 1989.

Cummings, Jack, Real Estate Financing and Investment Manual, Prentice Hall, 1997.

Fabozzi, F. and Modigliani, F: Mortgage and Mortgage-Backed Securities Markets, Harvard Business School Press, Boston, 1992.

Ferran, E: Mortgage Securitization: Legal Aspects, Butterworth's, London 1992.

Glaeser, E. and Kallal, H: "Thin Markets, Asymmetric Information and Mortgage-Backed Securities", Journal of Financial intermediation 6, 1997.

Hayre, L., Salomon Smith Barney Guide to Mortgage-Backed and Asset-Backed Securities. John Wiley & Sons Inc, 2001.

Hendershott, P. H. and J. D. Shilling, The impact of the agencies on conventional fixed rate mortgage yields. Journal of Real Estate Finance and Economics 2(2), 101–15, June 1989.

Hendershott, P. H. and R. Van Order, Pricing Mortgages: An Integration of Mortgage and Capital Markets and the Accumulation of Residential Capital, Regional Science and Urban Economics, 189 – 210, May 1989.

Bibliography and References

Higgins, Eric and Joseph Mason, "What is the Value of Recourse to Asset Backed Securities? A Study of Credit Card Bank ABS Rescues," Journal of Banking and Finance, 28, pp. 857-874, 2004.

Hu, Jian and Richard Cantor, "Defaults and Losses Given Default of Structured Finance Securities," Journal of Fixed Income, March 2004.

Jobst, A, "Need for Vigilance by CDO Investors," Financial Times, Comments & Letters (4 November 2005).

Jobst, A, "Investors Must Heeds Those CDO Risks," Financial Times, Comments & Letters (19 April 2005).

Kau, J., Keenan, D., Muller III, W. and Epperson, J.F. (1993): "Option Theory and Floating Rate Securities with a Comparison Adjustable and Fixed Rate Mortgages" Journal of Business Volume 66, no 4, 1993.

Kolari, J. W., D. R. Fraser, and A. Anari, The effects of securitization on mortgage market yields: A co integration analysis. Real Estate Economics 26(4), 677–93, 1998.

Lucas, Douglas L., Goodman, Laurie S., and Fabozzi, Frank J. Collateralized Debt Obligations: Structures and Analysis, 2nd Ed. Hoboken, NJ: Wiley, 2006.

Mattey, J., and N. Wallace, 1998, Housing prices and the (in) stability of mortgage prepayment models: Evidence from California, Working Papers in Applied Economic Theory 90-05, Federal Reserve Bank of San Francisco

Mattey, J., and N.Wallace, 2001, Housing price cycles and prepayment rates of U.S.mortgage pools, Journal of Real Estate Finance and Economics 23, 161 184.

Mayer, C., and D. Genesove, 1997, Equity and time to sale in the real estate market, American Economic Review June, 255–69.

Monte Carlo: Methodologies and Applications for Pricing and Risk Management, Bruno Dupire, Ed, RISK Books.

Moody's Perspective 1987-1999 "Securitization and Its Effects on the Credit Strength of Financial Services Companies:" July 1999.

Monsen, G., 1992, The new thinking on prepayments, Mortgage Banking October, 48-56.

Naranjo, A. and A. Toevs, The effects of purchases of mortgages and securitization by government sponsored enterprises on mortgage yield spreads and volatility. Journal of Real Estate Finance and Economics 25, 173–96, 2002.

Bibliography and References

Oldfield, George. "Making Markets for Structured Mortgage Derivatives," Journal of Financial Economics, Vol. 57 (2000), 445-471.

Passmore, W., S. M. Sherlund, and G. Burgess, The effect of housing government sponsored enterprises on mortgage rates. Real Estate Economics 33(3), 427–463, 2005.

Path Generation for Quasi-Monte Carlo Simulation of Mortgage-Backed Securities, Fredrik Akesson and John P. Lehoczky, Management Science, Vol. 46, No. 9, September 2000, pp1171{1187.

Powelson, Richard, Formulas for Wealth, Skyward Publishing, 2001.

Riddiough, T: "Optimal Design and Governance of Asset-Backed Securities", Journal of Financial Intermediation 6, 2001.

Skarabot, J, "Securitization and Special Purpose Vehicle Structures," Working Paper, Haas School of Business, University of California at Berkeley, 2002.

Stein, J. C., 1995, Prices and trading volume in the housing market: A model with down payment effects, Quarterly Journal of Economics May, 379–406.

Walsh, P: "Recent Developments in the UK Mortgage Backed Securities Market", in The UK Mortgage Market-Securitization and Portfolio Sales, Ed. The Council of Mortgage Lenders, October 1995.

The US Securities Act of 1933 § 11. 77k (a), available at http://www.sec.gov/about/laws/sa33.pdf. See e.g. ("In case any part of the registration statement, when such part became effective, contained 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 (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue – … (5) every underwriter with respect to such security.").

The Exchange Act of 1934

Structured Credit Investor, Feb 2, 2007, available at http://www.structuredcreditinvestor.com/story.asp?PubID=250&ISS=22088&SID=15658

www.nva-mortgage.com – home page for Carteret mortgage. Excellent discussions of underwriting criteria for nonconforming and investor loan programs.

www.hud.gov – government Web site for HUD, with dozens of articles about FHA investor loans.

Bibliography and References

www.fanniemae.com – Federal National Mortgage Association's official Website.

www.Hsh.com – publishers of mortgage information for consumers.

www.realtytimes.com – industry news about real estate and mortgages.

www.realestateabc.com – CNBC Power Lunch "cool site of the day." Excellent articles about the real estate and mortgage industry and different types of loan programs.