SECURITIES LAW360

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Securities Fallout From The Subprime Lending Crisis

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* Introduction *

In the last few years, lenders have made increasing numbers of mortgage loans to borrowers with poor credit histories. Many of these loans, typically called subprime loans, require little or no down payment and little documentation of the borrower's financial condition. Many have features that cause monthly debt service payments to increase over time.

Some estimate that subprime loans account for approximately 20% of the $3 trillion mortgage market. Much of this growth has been fueled by the liquidity provided by the securitization market, through which financial institutions issue high-yielding securities collateralized by these subprime loans to investors, whose return naturally depends on the performance of the underlying mortgages.

Recently, however, borrowers have experienced well-publicized difficulty in making their monthly payments on these mortgages. Naturally, this is having an adverse effect on the performance of the securities backed by such loans, causing serious questions about the future performance and current value of such securities.

This uncertainty has greatly decreased the liquidity in the market for securities backed by subprime loans, which in turn has made it far more difficult for would-be home buyers to obtain mortgage financing.

A wide variety of interested parties are calling for political and regulatory responses, but there is much uncertainty as to whether there will be any political or regulatory responses at all, much less what those responses will be or what impact they will have.

The political and regulatory situation is complicated by the fact that the securitization market for subprime mortgages has provided tremendous liquidity to mortgage lenders, which has provided many homeowners with access to loans, and thereby houses, that were otherwise out of their reach.

Any regulatory changes to the market could easily have ramifications that reach beyond Wall Street to Main Street.

While there is much uncertainty over the potential political and regulatory responses, there is corresponding certainty that the crisis in the subprime mortgage market will generate significant amounts of litigation. This article examines the likely nature of and parties to that litigation.

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* The Subprime Securitization Market *

To understand the litigation that may be generated by the problems in the subprime market, it is important to understand the general mechanics of the subprime securitizations.

While there are many different ways a subprime mortgage can be securitized, generally speaking, a loan originator makes a loan, which has features designed to ease the burden of debt service in the early term of the loan, to a home purchaser with substandard credit.

Typically, the originator then sells the loan to a financial institution, such as an investment bank. This enables the loan originator to make the loan without having to commit the capital to fund and carry the loan. The originator profits from various fees it charges and from the sale of the loan to the investment bank.

The investment bank then usually conveys the loan, along with many other loans with generally similar terms and features, to a bankruptcy remote, special purpose entity, typically a trust.

Under current Generally Accepted Accounting Principles, namely FAS 140, such conveyances are eligible for what is referred to as “gain on sale” accounting treatment, which obviates the need for the investment bank to carry the indebtedness on its own books and records. The trust then issues securities collateralized by the loans held by the trust.

FAS 140 allows the investment bank to record a gain on the sale of the loans to the trust. The bank may also retain an asset on its balance sheet, commonly referred to as a “residual,” which broadly speaking represents the difference between the yield actually generated by the mortgage loans, which serve as collateral for the securities issued by the trust, and the yield of those securities.

The securities issued by the trust are usually rated by one of the major credit ratings agencies. Financial institutions that desire to purchase high-yielding, collateralized securities rated by a major ratings agency then purchase the securities, thereby providing a substantial amount of liquidity to the subprime mortgage market.

Over the past few years, there has been an environment of increasing housing prices which has enabled borrowers, through refinancings or house sales, to cope with increasing debt service requirements of subprime loans, caused by factors such as increases in interest rates due to the resetting of adjustable rate loans.

However, the slowdown in the housing market has greatly impeded subprime borrowers’ ability to deal with such increases. This has caused numerous delinquencies, defaults and foreclosures.

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The foreclosure trend is anticipated to increase, given that over $500 billion in adjustable rate home loans, of which over 70% are to subprime borrowers, are estimated to reset at higher interest rates by the end of 2007. And $600 billion more will adjust in 2008.

The poor performance of the collateral underlying the securities, the mortgages, directly causes the securities to yield less than they otherwise would have.

This obviously reduces the investment income realized by the purchasers of the securities, but it also may affect the purchasers' balance sheets because the reduced cash flows reduce the fair market values of those securities, possibly requiring those assets to be written down in value.

* Addressing the Subprime Meltdown Through Regulation *

The situation in the subprime market has riveted the attention of regulatory agencies and Congress. Numerous reforms are currently being considered, and some form of regulation may be inevitable.

One of the steps the SEC has taken is to attempt to provide some latitude to loan servicers in attempting to negotiate workout arrangements with distressed borrowers.

Under FAS 140, there is a general requirement that collateral for securitizations cannot be actively managed after the securitization is completed unless there is an actual default. This requirement would on its face apparently preclude a servicer of a subprime loan from negotiating a workout arrangement, such as a restructuring, with a distressed borrower who is not actually in default.

In an effort to give servicers flexibility in dealing with distressed borrowers, in July 2007, SEC Chairman Christopher Cox publicly stated that securitized loans may be modified when default is "reasonably foreseeable," without affecting the applicability of the highly favorable gain-on-sale treatment allowed by FAS 140.

Chairman Cox's approach has substantial support. Federal Reserve Chairman Benjamin Bernanke recently encouraged banks to work with distressed borrowers in modifying or refinancing loans in order to avoid default and foreclosure.

Also, a September 4, 2007 joint statement issued by a number of agencies — including the Federal Deposit Insurance Corporation, the Office of the Comptroller of Currency, and the National Credit Union Administration — to servicers of securitized mortgages encourages servicers to "pursue strategies to mitigate losses while preserving homeownership to the extent possible and appropriate."

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The statement more specifically encourages servicers of securitized mortgages to examine the contracts and governing documents for their securitization trusts to determine the extent to which they can restructure loans “that are delinquent or in default or are in imminent risk of default.”

Moreover, the joint statement defines a default to be “‘reasonably foreseeable’ when a lender has made actual contact with the borrower, has assessed the borrower’s ability to pay, and has a reasonable basis to conclude that the borrower will be unable to continue to make mortgage payments in the foreseeable future.”

Also on September 4, 2007, Congressman Barney Frank encouraged lenders to work toward flexible payment agreements with borrowers at risk of default. He has advocated governmental regulation of the securitized subprime markets, such as that in the banking industry.

* The Inevitable Role of Litigation *

Whatever the political and regulatory response may end up being, litigation will undoubtedly play a major role in striving for accountability. While the battle lines have not yet been drawn completely, each party involved in the complex web of securitized subprime mortgage transactions may face liability exposure.

NovaStar Financial, Accredited Home Lenders, Wells Fargo, First Franklin Financial Corp., and Coast Financial Holdings LLC, are just a few examples of subprime lenders currently caught up in litigation with either shareholders or borrowers. Moreover, since December 2006 at least 17 originators of subprime loans have sought bankruptcy protection.

* Possible Claims Against Securitizers *

Securitizers may face claims from two primary sources: those institutions that purchased the collateralized securities from the trusts, and their own shareholders.

Possible claims by securities purchasers may include a wide range of legal theories based on allegedly inadequate disclosures, from federal securities law claims to state law claims. However, any such claims will be impeded by the fact that the securities were issued, not by the companies responsible for the securitizations, but by the trusts that are separate and distinct legal entities and which typically hold no assets other than the collateral itself.

Publicly held securitizers may be forced to confront very difficult accounting issues, such as whether gain-on-sale treatment under FAS 140 was appropriate in the first instance, whether the original complex calculations of the gains on the sales of the collateral were reasonable, and whether the residuals the securitizers carry on their balance sheets as assets are impaired and should be written down.

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These issues could well lead to restatements of previously issued financial statements or charges to reduce the carrying value of residuals. If so, the securitizers may well face securities class litigation, through which shareholders of the securitizers may claim that they were misled by the misleading or incomplete disclosure concerning these issues.

* Possible Claims Against Underwriters *

If underwriters that are separate and distinct from the securitizers were involved in an offering of collateralized securities, they could well face similar claims concerning the adequacy of disclosures relating to the creditworthiness of the borrowers, the terms and features of the loans, the risks attendant to the securities, and a whole host of additional disclosure issues.

* Possible Claims Against Loan Originators *

Securitizers may have claims against loan originators based on, among other things, the contractual agreements between the loan originators and the securitizers, such as agreements for the sales of the loans.

* Possible Claims Against Ratings Agencies *

Recently, there has been criticism of major ratings agencies for their ratings of structured finance products generally, and more specifically for their purported failure to take action as soon as they should have given the performance of the assets underlying those securities, and for not maintaining appropriate independence from the issuers and underwriters of those securities.

The SEC is currently reviewing the ratings agencies, the services they have provided to mortgage originators and underwriters, their ratings practices and processes, and whether they are subject to potential conflicts of interest. This scrutiny could well lead to claims of negligence, negligent misrepresentation and other similar claims by the purchasers of the securities subject to the ratings.

* Possible Claims Against Auditors *

Auditors who audited or reviewed a securitizers accounting treatment under FAS 140 may well face claims if the original judgments concerning the propriety of gain-on-sale treatment, or the calculations of the gains or residuals, are later determined to have been in error. Such claims could be based on numerous state and federal laws, including the federal securities laws.

In fact, Deloitte & Touche, Ernst & Young, and Grant Thornton LLP have already been sued in connection with securitized subprime loan transactions.

* Possible SEC Enforcement Cases *

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While the SEC does not directly regulate the origination and sale of mortgage loans, it does have a regulatory role when the mortgages are securitized and sold to the investing public.

Undoubtedly, the SEC will conduct investigations of numerous situations in the subprime securitization market. Since June 27, 2007, the SEC has opened at least 12 investigations into potential securities fraud related to securitization and sale of subprime loans, and this number will almost certainly increase in the future.

* Conclusion *

While we must wait and see whether and to what extent there is any particular political or regulatory response to the crisis in the subprime market, various participants in the subprime mortgage securitization process face significant liability exposure in the litigation that is sure to come.

--By Steven S. Scholes

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