

U.S. subprime probe could benefit CDO investors

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Prospects have improved for investors seeking compensation from banks that arranged collateralized debt obligations, aided by the findings of a federal task force to investigate fraud in U.S. residential mortgage market and by information gleaned from lawsuits into the underwriting of residential mortgage backed securities.

A large proportion of disputed CDOs, contained residential mortgage backed securities, or RMBSs, which have underperformed since the subprime crisis erupted in late 2008. What investors are hoping to prove is banks committed fraud when they knowingly packaged mortgages of dubious quality into RMBSs and sold them contrary to what was represented in offering circulars and prospectuses. These same securities were also widely packaged into CDOs.

John Padrnos, partner at structured credit specialist firm Devon Capital, told Thomson Reuters: "What's happening is they're peeling back the onion. What they've looked at is the question of how much did the banks know about the declining credit quality in the mortgages that were being originated and the impact that would have on investors."

So whereas previously it was difficult to prove fraud, these RMBS cases coupled with whatever new information the mortgage fraud task force unearths, could help CDO investors recoup losses. For example, if it is proven that banks knew the RMBSs they were structuring were backed by poor quality loans, then CDO investors' suits would stand a better chance in court.

Zachary Rosenbaum, chair, capital markets litigation at Lowenstein Sandler, said: "The information that has become public since the middle of 2010 based upon congressional hearings and the report by the Financial Crisis Inquiry Commission that supports the complaints, was not available to investors between 2008-2010. Some CDO investors really lost out because they entered the litigation early. If you read the RMBS complaints they're a combination of analytics by experts and information that's become public in the last two years."

Last month, President Obama announced the formation of the mortgage fraud task force, a joint venture of state and federal agencies and prosecutors including the Securities and Exchange Commission, the U.S. Department of Justice and New York Attorney General Eric Schneiderman. The task force is charged with investigating fraud involving home loans and mortgage securities. Previous investigations by the Financial Crisis Inquiry Commission and the Financial Fraud Task Force have thrown light on the causes of the financial crisis and targeted mortgage brokers, respectively. The latest task force, however, is expected delve more deeply into market practices around mortgage origination and securitization.

Investors must make a decision soon about pursuing arranging banks for damages, because the statute of limitations on fraud in New York State, where most of the suits have been filed, is six years. Many of the CDOs being disputed by investors were bought in 2007.

Judges unsympathetic to investors

CDO investors had started to take legal action against banks even before Lehman Brothers' bankruptcy in September 2008 and the pursuant credit crunch. Litigation continued into 2009, and there were a few settlements and favourable decisions for investors. However, CDO litigation dwindled somewhat as investors largely have failed to find much sympathy in court and many cases were dismissed.

Some judges have taken the view that so-called sophisticated investors should have known better than to get mixed up in complex securities they did not truly understand. Equally on the banking side, there has been a bit of frustration about investors taking profits when exotic products perform well and taking their bankers to court when they flop. In court, the complexity of CDOs investments are said to be to the banks' advantage. Judges' decisions on why they are dismissing a case are quite difficult to understand, observe structured credit experts.

One industry official told Thomson Reuters: "[Judges will] say: You're suing the bank, but you should be suing the

issuer ?which everyone knows is a post box in the Cayman Islands. You know there's no money on the issuer level. You see inconsistency on the judges reasoning. It's a little bit disappointing."

See you in court

As the investors see the statute of limitation on 2007 vintage RMBSs and CDOs coming quickly upon them, there has been a return to the courts, particularly on the RMBS side. Starting in the third quarter 2011, investors started to sue and in the U.S. there already is huge amount of litigation pending in regards to these securities.

Saul Haydon Rowe, partner at Devon Capital, said: "In the last three months CDO suits are popping back up, because investors are attacking the RMBS securities upon which they are based, which means they can now attack the CDOs in a different way."

In addition, CDO investors have learned from their colleagues early attempts to seek compensation through the courts. To avoid having cases dismissed early on, plaintiffs are changing their approach to show that even sophisticated investors could have been duped.

Gene Phillips, director at PF2 Securities Evaluations, told Thomson Reuters: "The judges seem to be less sympathetic for sophisticated investors so one notices a change in recent complaints moving towards trying to show that even sophisticated investors may not have privy to certain changes in market dynamics, or may not have been able to identify some of the obfuscation that was occurring. The plaintiffs have realized they have to meet higher pleading standards especially if their clients are sophisticated investors, so they've really had to adjust their approach to survive motions to dismiss."

It will not be easy. Investors taking their banks to court will have to get past the critical motion to dismiss stage and get into real discovery phase of the proceedings. With the statute of limitation set to expire, the clock is ticking on these toxic 2007 deals.

RMBS suits allege shady dealings

Already lawsuits alleging wrongdoing by Wall Street firms' mortgage units are giving other investors fresh information about firms' conduct in the run up to the subprime crisis. Last year, bankrupt bond insurer [Ambac Financial](#) renewed its suit against JP Morgan, which bought Bear Stearns when it went bankrupt in 2008. Ambac contends that Bear Stearns packaged bad loans into insured securities and that as Bear's acquirer, JPMorgan, failed to honour a variety of contractual promises.

The suit alleges that the Bear traders sold toxic mortgage securities to investors and then would sell back the bad loans in the RMBSs with early payment defaults to the originating banks at a discount. The traders would pocket the refund instead of passing it on to the mortgage trust, where it should have been distributed to the investors who owned the bonds.

Morgan Stanley and Wells Fargo face similar allegations, while a \$8.5 billion settlement for investors against Bank of America is awaiting court approval. Meanwhile, most large U.S. banks have earmarked billions to go towards buying back busted RMBSs, mortgages and to pay legal fees related to the subprime crisis.

Big settlement?

Last week, the Obama administration announced a \$25 billion [settlement](#) with Bank of America, Wells Fargo, JPMorgan Chase, Citigroup and Ally Financial over foreclosure abuses. If the mortgage fraud task force finds that misconduct in mortgage origination and the subsequent packaging into mortgage securities was as widespread and similar as is alleged, the banks could be heading toward another big settlement.

The banks simply could not withstand having to refund every investor in every RMBS or CDO transaction found to be fraudulent. There may be a point where for the sake of the financial system, the government could be forced to draw a line under claims related to mortgage securities.

Rosenbaum said: "There is a balance between how much they will and should pay and putting this piece of American history behind us."

For details on the national mortgage settlement, [please click here.](#)