Ready for Another Big Bank Crisis? Bailout?

A day of reckoning is coming for the investment banks whose securities fraud caused the 2008 financial crisis.

INTERVIEW BY CHRIS MCFADYEN

A watershed of lawsuits now breaking across the country could cause another crisis among the largest investment banks — the same banks that were bailed out in 2008, at the start of the first financial crisis.

Little press attention has been paid to the issue, because individual cases have been treated as separate stories, at least until recently. In a Dec. 9 story, "Mortgage Crisis Presents a New Reckoning to Banks," the New York Times was among the first to report that this "fresh torrent of lawsuits" could dwarf the "tens of billions of dollars the banks have already paid to settle other cases" and could total as much as another $1 trillion in total compensation.

"All of Wall Street has essentially refused to deal with the real costs of the litigation that they are up against," the Times quoted Christopher Whalen, a senior managing director at Tangent Capital Partners. "The real price tag is terrifying."

To get a grip on the matter, we turn to Tom Krebs, former director of the Alabama Securities Commission, who was assistant director and deputy general counsel of the Financial Crisis Inquiry Commission, which Congress set up to study the financial crisis that began in 2008. He now practices law with the Birmingham firm Christian & Small.

The number and variety of these lawsuits can be perplexing. Plaintiffs range from investors to federal agencies to federal and state prosecutors. So far, most are civil cases but many more criminal charges are promised by prosecutors, such as New York Attorney General Eric Schneiderman. Among the many cases brought by the FDIC on behalf of failed banks is one representing Colonial Bank (See "FDIC Says Wall Street Defrauded Colonial," Business Alabama, Sept. 2012.)

Out of this roiling pot of legal stew, however, there is one common ingredient. The reason for the current run of lawsuits, Krebs says, is the basic cause of the financial crisis: securities fraud committed on a massive, system-wide basis by a raft of the largest investment banks.

"The total for all such cases could be as much as $1 trillion or $1.2 trillion or $1.5 trillion." — Tom Krebs, former assistant director of the Financial Crisis Inquiry Commission.

The ultimate cause of the financial crisis was nothing more than what it was in 1929 — securities fraud. It was committed in connection with the huge number of mortgage-backed securities offerings that were sold.

The failure to disclose that loans in the pool did not meet the issuers' underwriting guidelines is securities fraud. That's why there is the huge number of cases that have been filed against the issuers — the securitizers, the investment banks — by the SEC, the FDIC, the FHFA (Federal Housing Finance Agency, the receiver for Fannie Mae and Freddie Mac) and other federal agencies.

There was a real shift in the market beginning in 2003 and running through the first quarter of 2007. The securitizers of real estate-backed mortgages, the investment banks, got into a race to write as many mortgages as they could. The MBS (mortgage-backed securities) issuers wanted volume and not quality, and they were taking loans they ordinarily would not take.

They made money for a time, to be sure. But now we're in the throes of determining how little they make, as a result of federal inquiries and criminal investigations and states suing them for engaging in fraudulent activities. The day of reckoning is coming.

The FHFA examined the loans in the pools that were sold, studied them for a year, and they came back and said the offering documents overstated the percent-

age of owner-occupied homes; overstated the loan-to-value ratios; misstated the down payments. There is not a definitive point used in the analysis that the securitizers did not misstate.

Clayton Holdings was doing 50 percent of the due diligence analysis for the securitization firms. In early 2006, Clayton saw the quality of the loans was deteriorating. They began a study that looked at 911,039 loans they reviewed from 2006 through the second quarter of 2007, and they discovered that only 54 percent met underwriting guidelines as stated by the securitization firms. Eighteen percent did not meet the guidelines but had compensating factors, and 28 percent of the loans did not meet underwriting guidelines and had no compensating factors.

Clayton told their client, and the securitizers were outraged that Clayton had engaged in such a search.

The FHFA and FDIC and other federal regulators have began to re-track what Clayton did, taking a statistically significant sample of the securities and finding misrepresentation on loan-to-value ratios and owner-occupied percentages. So they have begun their own sampling, and the courts have allowed it and permitted them to introduce these studies they have done, because they are alleged with such specificity that it has created the presumption that something isn't right.

Thus far, when these cases have gotten to the point of going to a jury, most of the defendants are settling out of court. Total investments in FHFA cases against 19 banks come to over $176 billion. I haven't run the numbers, but the total for all such cases could be as much as $1 trillion or $1.2 trillion or $1.5 trillion.

The regulators can always come back with enforcement after the fact. But the real protection for the investor is the pre-issuance oversight, and that was done away with. The regulations were changed, and the MBSs were sold in a shelf offering. No regulator was looking at what was being said and comparing it to the underlying pool of loans. There were so many of these things done between 2003 and 2007, over 7,400 of these securitizations — or 1,400 a year or more than four a day — there was no way the staff of the SEC could begin to review the MBSs proposed for a shelf offering.

The change in regulations was done by the SEC at the urging of Congress, and it seemed like a good idea at the time, 1984 — for the purpose of expanding the mortgage industry. It became a problem in 2003, when it was abused and there became a 28 percent probability of deficiency. There was so much money to be made. They concentrated on the volume rather than the quality. They knew they weren't telling the truth.

The Department of Justice and the prosecutors of the states of New York and Massachusetts are really taking them on. There are huge amounts of funds that these securitization firms are liable for.

The government is engaged in a program to keep these institutions from getting into real trouble, buying bonds back, and they can do the same with the bonds represented by the MBSs — just as they did with Bear Stearns. There is a significant belief that a number of those loans can be rehabilitated.

There is also a possibility that we might have to break up some of the biggest banks, and that's been discussed through this notion of too big to fail. Under Dodd Frank there is a mechanism in place to take them apart and sell off those pieces that make money. The buyers would be the surviving banks. There are a heck of a lot of other financial institutions that are not a part of it and not even in the mortgage business.

Chris McFadyen is the editorial director of Business Alabama.

BLACKER SOIL. BIGGER GAME. BETTER STORIES.

Our rich, black soil provides the perfect nutrients to create a fertile habitat for an abundance of wildlife. And, our 23 county region boasts a well-deserved reputation for hunting and fishing, producing monster whitetail bucks and lunker bass on a regular basis. The Black Belt region has one of the largest populations of wild turkey and offers other bird hunts such as quail, dove, and duck. Our seasons are long and bag limits generous. For the passive recreation enthusiasts there's birdwatching, hiking, biking, canoeing, camping, and great photo opportunities. Our cultural heritage is as rich as the soil and the southern cooking even better. Be sure to bring your appetite! And, you'll have lots of fun at our unique events and festivals. We invite you to visit our website to learn more about Alabama's Black Belt region. You won't be disappointed!

877.849.0767 | alabamablackbeltadventures.org