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ZACHARY S. GILREATH*

The Culprit of the Great Recession: A Detailed Explanation of Mortgage-Backed Securities, their Impact on the 2008 Financial Crisis, and the Legal Aftermath

“What we know about the world financial crisis is that we don’t know very much.”¹ Though not a prophet, economist and Nobel Peace Prize winner Paul A. Samuelson² recognized in 1999 that financial market meltdowns are extremely difficult to predict or understand. Sure enough, the United States’ failure to recognize an imminent financial meltdown resulted in the worst housing market collapse³ since the Great Depression.⁴ While many factors led to what is commonly referred to as the Financial Crisis of 2008,⁵ the securitization of residential mortgages by financial institutions is arguably the chief culprit.⁶

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1. *The “Other” Samuelson*, THE GLOBALIST (Apr. 18, 2001), <https://www.theglobalist.com/the-other-samuelson/>.

2. *Paul A. Samuelson – Biographical*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1970/samuelson-bio.html (last visited Apr. 23, 2017). Samuelson won the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 1970. *Id.*

3. Joel Havemann, *The Financial Crisis of 2008: Year in Review 2008*, ENCYCLOPEDIA BRITANNICA, <https://www.britannica.com/topic/Financial-Crisis-of-2008-The-1484264> (last updated Feb. 2, 2009).

4. The Great Recession is a term that represents the sharp decline in economic activity during the late 2000s. This period of time is also commonly referred to as the Financial Crisis of 2008. *The Great Recession*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/great-recession.asp> (last visited Apr. 24, 2017).

5. Some economists argue that factors such as lenient lending standards, overconfidence of financial institutions, and outright fraud were all factors that led to the financial meltdown. Max Ehrenfreund, *Think You Know the Cause of the US Financial Crisis? You Could be Wrong*, WORLD ECON. F. (Jan. 31, 2017), <https://www.weforum.org/agenda/2017/01/the-cause-of-the-us-financial-crisis-wasnt-what-you-think-according-to-these-economists>.

6. Havemann, *supra* note 3.

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This paper will provide a detailed explanation of the history of mortgage-backed securities (“MBS”), the Financial Crisis of 2008, and the impact MBS has had on securities litigation nationwide. Part I will explain how mortgages have progressed within the United States and detail the creation of the first MBS.⁷ Part II will discuss the growth of the MBS market and innovations that followed, looking at those that had an impact on the crisis.⁸ Part III will examine the Financial Crisis of 2008 and how the MBS market was impacted by the housing market collapse.⁹ Finally, Part IV analyzes securities litigation prior to 2007-08 and litigation following the financial crisis, focusing on how the posture of courts has evolved with respect to claims brought by shareholders.¹⁰

I. THE CREATION OF MORTGAGE-BACKED SECURITIES

In order to understand the mortgage-backed security market and the risky innovations that followed, one must first understand the progression of the mortgage and the government entities created to monitor mortgage lending. Subsection A briefly discusses mortgages and how they progressed until the government began establishing government-sponsored entities (“GSEs”) to focus on the rising costs of homeownership.¹¹ Subsection B offers background knowledge regarding GSEs, mortgage programs that eventually established the first mortgage-backed security.¹² Finally, subsection C explains how and why GSEs began issuing mortgage-backed securities.¹³

A. *What is a Mortgage?*

A mortgage is a debt instrument secured by the collateral of specified real estate property that the borrower is obliged to pay back with a predetermined set of payments.¹⁴ Individuals and businesses use mortgages to make large real estate purchases without paying the entire value of the purchase at one time.¹⁵ In a residential mortgage, a homebuyer pledges his or her house to the bank.¹⁶ The bank has a claim on the house should the homebuyer default on paying the mortgage.¹⁷

7. *See infra* Part I.

8. *See infra* Part II.

9. *See infra* Part III.

10. *See infra* Part IV.

11. *See infra* Part I.A.

12. *See infra* Part I.B.

13. *See infra* Part I.C.

14. *Mortgage*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mortgage.asp> (last visited Apr. 24, 2017).

15. *Id.*

16. *Id.*

17. *Id.*

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Prior to the Great Depression, homeowners typically renegotiated the terms of their mortgages every year.¹⁸ During that period, mortgages had very low loan-to-value ratios and did not place substantial stress on lenders.¹⁹ However, during the Great Depression, property values plummeted, forcing mortgage holders to refuse to refinance loans that came due—this led to millions of borrowers defaulting and homes being foreclosed on by holders.²⁰ At the peak of the financial crisis, nearly 10 percent of homes were in foreclosure.²¹

In response to the problems created during the Great Depression, the United States government began intervening in the housing finance market. As well as establishing a number of mortgage programs and institutions discussed below, the government also invented the fixed-rate, self-amortizing, long-term mortgage.²² The addition of the government in the home financing arena helped establish numerous programs that helped alleviate some costs associated with home buying, but also led to problems that will I will address in the following sections.

B. Government-Sponsored Enterprises

In 1933, the U.S. government established the Federal Housing Administration (“FHA”) mortgage insurance program.²³ In 1944, the Veteran Administration (“VA”) mortgage guarantee program was established.²⁴ Both of these programs provided a federal guarantee for mortgage investors, as was typical for government entities.²⁵

In 1938, The Federal National Mortgage Association (“FNMA”), more commonly referred to as “Fannie Mae,” was created.²⁶ By 1968 the FNMA was privatized as a shareholder-owned entity with the right to buy and sell both government-sponsored and non-government-sponsored loans so long as the loans met certain guidelines.²⁷ Much like the mortgage guarantee houses of the 1800s, Fannie Mae issued bonds to support its loan purchases.²⁸

18. Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSP., no. 4, 2005, at 93, 93.

19. *Id.* at 94.

20. *Id.* From 1931 until 1935, 250,000 homes were foreclosed on annually. *Id.*

21. *Id.* at 94–95.

22. *Id.* at 95.

23. John McConnell & Stephen A. Buser, *The Origins and Evolution of the Market for Mortgage-Backed Securities*, 3 ANN. REV. FINANC. ECON., 2011, at 173, 176.

24. *Id.* at 176.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

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In 1968, the federal government established the Government National Mortgage Association (“GNMA”), also known as “Ginnie Mae.”²⁹ Two years later, the Federal Home Loan Mortgage Corporation (“FHLMC”) was created.³⁰ Today, the FHLMC is more commonly referred to as “Freddie Mac.”³¹ As with Fannie Mae, Freddie Mac was established as a shareholder-owned corporation with no explicit government guarantee,³² although most investors viewed Fannie Mae and Freddie Mac as having an implicit government guarantee.³³ Ginnie Mae was chartered for a different reason: to issue mortgage-backed securities supported by FHA and VA mortgage loans and to guarantee timely payment of interest and principal loans used to support Ginnie Mae MBS.³⁴

Ginnie Mae, Fannie Mae, and Freddie Mac are all considered government-sponsored enterprises.³⁵ A GSE consists of privately held corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy.³⁶ GSEs carry the implicit backing of the U.S. government, but they are not direct obligations of the U.S. government.³⁷ For this reason, these securities will offer a yield premium over Treasuries.³⁸ These GSEs focusing on mortgages were established because some thought that a national mortgage market would reduce the cost of home ownership by creating a more liquid market.³⁹

C. Mortgage-Backed Securities

The mortgage-backed security was created in an attempt to further reduce the cost of home financing.⁴⁰ In 1968, Ginnie Mae provided assistance in the form of a guarantee for a privately issued mortgage-backed security.⁴¹ The first MBS offered by

29. McConnell & Buser, *supra* note 23, at 176.

30. *Id.*

31. Kimberly Amadeo, *What is Freddie Mac?*, BALANCE, <https://www.thebalance.com/what-is-freddie-mac-3305985> (last updated Mar. 31, 2017).

32. McConnell & Buser, *supra* note 23, at 176.

33. This view was substantiated in 2008 when both entities were placed into conservatorship under the auspices of the United States government. *Id.*

34. *Id.*

35. *Id.* at 174.

36. *Government-Sponsored Enterprise – GSE*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/gse.asp> (last visited Apr. 24, 2017).

37. Only loans that meet certain criteria are acceptable for securitization under the auspices of GSEs. McConnell & Buser, *supra* note 23, at 174.

38. *Government-Sponsored Enterprise – GSE*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/gse.asp> (last visited Apr. 24, 2017).

39. McConnell & Buser, *supra* note 23, at 177.

40. *Id.* at 177–8.

41. *Id.* at 176.

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Ginnie Mae itself was in 1970 with a face value of \$70 million.⁴² Freddie Mac and Fannie Mae issued their first MBS in 1971 and 1981, respectively.⁴³

A mortgage-backed security (“MBS”)⁴⁴ is a type of asset-backed security that is secured by a mortgage or collection of mortgages.⁴⁵ An MBS can be bought and sold through a broker and is issued by a federal government agency, GSE, or private financial company.⁴⁶ When an investor invests in an MBS, he is essentially lending money to a homebuyer or business.⁴⁷ An MBS is a way for a smaller regional bank to lend mortgages to its customers without having to worry about whether the customers have the assets to cover the loan.⁴⁸ Instead, the bank acts as an intermediary between the homebuyer and the investment market participants.⁴⁹ MBSs benefit the banks that sell them because they can be removed from the balance sheet, allowing such banks to acquire additional funding.⁵⁰

The process by which mortgages are pooled together to form MBS is quite sophisticated, which is why those who invest in MBSs typically put in a good deal of research to ensure that their investment matches their risk tolerance.⁵¹ First, mortgage loans are purchased from banks or mortgage companies and are then assembled into pools by a governmental, quasi-governmental, or private entity.⁵² The entity then issues securities that represent claims on principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.⁵³ Some private institutions, such as brokerage firms and banks, also securitize mortgages, known as “private-label” mortgage securities.⁵⁴

There are two common types of MBS. The first type of MBS issued by Ginnie Mae, Freddie Mac, and Fannie Mae are pass-through MBS, in which investors receive a pro rata fraction of monthly principal and interest payments from the underlying

42. *Id.* at 176–7.

43. *Id.* at 177.

44. An MBS is also known as a “mortgage-related security” or a “mortgage pass through.” *Mortgage-Backed Security (MBS)*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mbs.asp> (last visited Apr. 23, 2017).

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. Alexandra Yan, *Introduction to Asset-Backed and Mortgage-Backed Securities*, INVESTOPEDIA, <http://www.investopedia.com/articles/bonds/12/introduction-asset-backed-securities.asp> (last visited April 23, 2017).

51. *Id.*

52. *Fast Answers: Mortgage-Backed Securities*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answersmortgasesecuritieshtm.html> (last updated July 23, 2010).

53. *Id.*

54. *Id.*

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loans.⁵⁵ The second type of MBS, which developed as the MBS market grew, are collateralized mortgage or debt obligations.⁵⁶

II. The Mortgage-Backed Securities Market

The creation of the mortgage-backed security allowed lenders to sell the mortgages they made, thus replenishing their available capital and allowing them to lend again.⁵⁷ Because of the flexibility MBS offered lenders and the government guarantee implicitly given to the MBS issued by GSEs, the market grew exponentially. By 2010, the MBS had grown further, with outstanding issuance exceeding \$9 trillion.⁵⁸ Furthermore, the growth of the MBS market led to growth in other financial securities,⁵⁹ such as asset-backed securities.⁶⁰

As time progressed, the MBS market evolved and became more complex. The complexity and privatization of MBS arguably led to eventual economic turmoil the United States faced beginning in 2007. Subsection A discusses how the structure of MBS became more complex through the creation of collateral mortgage obligations.⁶¹ Subsection B explains the emergence of the private sector in the MBS business.⁶²

A. The Creation of Collateralized Mortgage Obligations

Freddie Mac issued the first collateralized mortgage obligation in 1983 and Fannie Mae issued its first collateralized mortgage obligation in 1985.⁶³ Collateralized mortgage obligations (“CMOs”), sometimes generally referred to as collateralized debt obligations (“CDOs”), allocate the cash flows from the MBS into tranches⁶⁴ that

55. McConnell & Buser, *supra* note 23, at 173, 177.

56. *See infra* Part II.A.

57. Chris Wilson, *What Is a Mortgage-Backed Security?*, SLATE (Mar. 17, 2008), http://www.slate.com/articles/news_and_politics/explainer/2008/03/what_is_a_mortgagebacked_security.html.

58. McConnell & Buser, *supra* note 23, at 173.

59. “For example, the first financial futures contract initiated in 1974 was backed by an MBS issued by Ginnie Mae (GNMA). As of 2011, trading in financial futures contracts comprised more than 90% of the total volume of all futures contracts in the United States.” *Id.* at 174.

60. “Other types of asset-backed securities (ABS) including securities backed by credit card debts, automobile and student loans, and equipment leases have followed the blueprint laid by MBS.” *Id.* An asset-backed security is a financial security back by a loan, lease, or receivable against assets other than real estate and MBS. *Asset-Backed Security – ABS*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/asset-backed-security.asp> (last visited Apr 23, 2017).

61. *See infra* Part II.A.

62. *See infra* Part II.B.

63. McConnell & Buser, *supra* note 23, at 177.

64. Tranches are pieces, portions or slices of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards and maturities. For example, a CMO offering a partitioned MBS portfolio might have mortgage tranches with one-year, two-year, five-year

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allow investors to choose among a wide array of payoff patterns.⁶⁵ These more complicated MBSs are designed to protect investors from or expose investors to various types of risk.⁶⁶

Initially, MBS faced only one type of risk: prepayment risk. Prepayment risk is the risk associated with the early, unscheduled return of principal on a fixed-income security.⁶⁷ Because of their long maturities, mortgages are susceptible to this risk.⁶⁸ If rates rise dramatically, the price of the bond can decline suddenly and the investor can suffer significant losses in value.⁶⁹ However, some fixed-rate mortgages can be paid off at any time, meaning if interest rates decline, mortgagors have an incentive to pay off their loans early so as to refinance at a lower rate loan.⁷⁰ Paying off a loan prior to maturity is known as the borrower's prepayment option.⁷¹ If a borrower pays off their loan before maturity, the holder of an MBS will not receive the anticipated stream of income at the agreed upon interest rate and will now have to reinvest their capital presumably at a lower interest rate.

The creation of CMOs was a way of overcoming the disadvantages of simple MBS in that an investor who preferred a short-term security could buy an early tranche, whereas one who was willing to bear more risk (possibly in return for a higher yield) would be attracted to the later pay tranches.⁷² The CMOs were structured so that the first tranche would receive all principal payments and interest from the underlying loans until the principal amount of the tranche was paid off.⁷³ Once the first tranche was paid off, the payments were disbursed to the second tranche.⁷⁴ Each tranche received its pro rata share of monthly interest payments based on the remaining principal outstanding in the tranche and the tranche's stated coupon rate.⁷⁵ These types of payoff structures were known as sequential pay bonds.⁷⁶

and 20-year, all with varying degrees of risk and return. *Tranches*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/tranches.asp> (last visited Apr. 24, 2017).

65. McConnell & Buser, *supra* note 23, at 174.

66. *Fast Answers: Mortgage-Backed Securities*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answersmortgagesecuritieshtm.html> (last updated July 23, 2010).

67. *Prepayment Risk*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/prepaymentrisk.asp> (last visited Apr. 24, 2017).

68. McConnell & Buser, *supra* note 23, at 177.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at 178.

73. *Id.* at 177.

74. McConnell & Buser, *supra* note 23, at 177.

75. *Id.* A coupon rate is the yield paid by a fixed-income security; a fixed-income security's coupon rate is simply just the annual coupon payments paid by the issuer relative to the bond's face or par value. *Coupon Rate*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/coupon-rate.asp> (last visited Apr. 24, 2017).

76. McConnell & Buser, *supra* note 23, at 177.

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Today, prepayment risk is not the only risk associated with MBS. As the private sector became a significant player in the MBS market over time, the structure of CMOs underwent significant innovation that added inherent risks.

B. The Emergence of the Private Sector

The growth of the MBS market in the 1990s brought with it not only innovation, but also competition. Though GSEs dominated the MBS market for nearly twenty years, the success of the MBS and the growth of the housing market⁷⁷ attracted private-label issuers like banks and other financial institutions.⁷⁸

While early CMOs were all backed by GSE insured or guaranteed mortgages, private label CMOs emerged in the mid-to-late 1990s.⁷⁹ As previously stated, GSEs carry with them an implicit government guarantee—the government bears the risk that mortgagors on the underlying loans will default.⁸⁰ However, investors in private label CMOs bear the risk that mortgagors will default.⁸¹ This risk was compounded due to the differences associated with GSE and private-label CMOs.

Government-sponsored enterprises can only securitize loans that meet certain criteria.⁸² These loans are referred to as conforming.⁸³ Private-label loans that are securitized do not meet these same standards; they are known as non-conforming loans.⁸⁴ Non-conforming loans consists of subprime and Alt-A loans,⁸⁵ which were created due to the higher demand for mortgages upon the addition of private financial services institutions into the MBS market. Typically, mortgagors only provided loans to prime borrowers, or those who had good credit and a steady source of income.⁸⁶ However, increasing the supply of mortgages available to be pooled into private-label MBS or CMOs forced mortgage lenders to loosen their typically strict

77. The proportion of households that owned their home increased from 64 percent that had prevailed in the 1970s to 69 percent by early 2006. JUNIOR ACHIEVEMENT USA, THE RISE AND FALL OF THE U.S. HOUSING MARKET: PAST, PRESENT, AND FUTURE 3 (2009), <https://www.juniorachievement.org/documents/20009/36541/Housing-Market-paper.pdf/63e03a3a-9561-4532-be0a-4311141ddb67>.

78. Private label offerings accounted for approximately 10% of the less than \$500 million of MBS issuances in 1996. By 1998, MBS issuances had nearly doubled to \$1 trillion, with private label offerings accounting for almost 40%. McConnell & Buser, *supra* note 23, at 179.

79. *Id.* at 178.

80. *Government-Sponsored Enterprise – GSE*, INVESTOPEDIA, <http://www.investopedia.com/terms/g/gse.asp> (last visited Apr. 24, 2017).

81. McConnell & Buser, *supra* note 23, at 178.

82. *Id.* at 174.

83. *Id.*

84. *Id.*

85. *Id.* Alt-A loans are those in which the risk profile falls between prime and subprime. The borrowers will typically have clean credit histories, but the mortgage itself will generally have issues that impact its risk profile. *Alt-A*, INVESTOPEDIA, <http://www.investopedia.com/terms/a/alt-a.asp> (last visited Apr. 24, 2017).

86. McConnell & Buser, *supra* note 23, at 180.

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lending standards, allowing those with poorer credit or no dependable source of income to receive home financing.⁸⁷ Mortgage dealers began issuing mortgages with terms unfavorable to borrowers, who were often families that did not qualify for ordinary home loans.⁸⁸ Some of these so-called subprime mortgages⁸⁹ carried low “teaser” interest rates in the early years that ballooned to double-digit rates in later years.⁹⁰ Some included prepayment penalties that made it prohibitively expensive to refinance.⁹¹

In 1969, the rate of homeownership in the United States stood at 64.3 percent.⁹² As of 1993, the rate stood at 64 percent.⁹³ However, beginning in 1994 when the private sector became involved in the MBS market and mortgage lenders began to provide subprime and Alt-A loans, the rate of home ownership increased until it reached its peak of 69 percent in 2006.⁹⁴ Subprime and near-prime loans shot up from 9 percent of newly originated securitized mortgages in 2001 to 40 percent in 2006.⁹⁵ In summary, millions of subprime mortgages were being issued even though these non-conforming loans lacked the same implicit guarantee provided to loans issued by GSEs.⁹⁶

The addition of private-label MBS opened the door for other private financial institutions to become involved in the lucrative market. For example, insurance companies entered the game by trading in credit default swaps.⁹⁷ However, these derivatives were often bought or sold by financial institutions on assets that they did not own, adding to the risk associated with private-label CMOs.⁹⁸ The actions of credit rating agencies compounded these risks. As with all loans, MBS and CMOs are

87. *Id.* at 181.

88. Havemann, *supra* note 3.

89. Subprime mortgages are extended to applicants deemed the least creditworthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risks and warrant the highest interest rates.” Danielle DiMartino & John V. Duca, *The Rise and Fall of Subprime Mortgages*, 2 ECONOMIC LETTER, no. 11, Nov. 2007, at 2.

90. *Id.* at 4.

91. *Id.*

92. McConnell & Buser, *supra* note 23, at 180.

93. *Id.*

94. *Id.*

95. DiMartino & Duca, *supra* note 89, at 2.

96. *Id.* at 2–3.

97. A credit default swap is a particular type of swap designed to transfer the credit exposure of fixed income products between two or more parties. In a credit default swap, the buyer of the swap makes payments to the swap’s seller up until the maturity date of a contract. In return, the seller agrees to pay the buyer the security’s premium and interest payments if the debt issuer defaults. *Credit Default Swap – CDS*, Investopedia, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Apr. 24, 2017).

98. Havemann, *supra* note 3. About \$900 billion in credit was insured by credit default swaps in 2001, increasing to \$62 trillion by the beginning of 2008. *Id.*

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rated by a credit rating agency⁹⁹ (“CRA”) based on their creditworthiness and the likelihood that the borrower(s) will pay back the loan within the confines of the agreement.¹⁰⁰ All loans are assigned a grade ranging from AAA to D; AAA-rated loans are considered excellent while any rating below BBB- is considered a junk bond.¹⁰¹

As the private sector became involved in the MBS market, CRAs were necessary to provide ratings for individual MBS and every tranche of CMOs. The ratings assigned to tranches of CMOs were especially important when it came to private-label CMOs because of the credit risk associated with subprime mortgages.¹⁰² Because tranches of subprime mortgages were more likely to reach default, CRAs were essential in assigning the correct tranche rating.¹⁰³

However, many argue that CRAs “colluded with issuers and awarded inflated ratings to lesser quality MBS, thereby further misleading investors.”¹⁰⁴ Credit rating agencies are paid by banks that request the CRA’s rating; in order to avoid losing customers to their competitors, CRAs had a strong incentive to issue high ratings to the banks’ securities.¹⁰⁵ Additionally, because CMOs “were new instruments, CRAs had little history on which to base their analys[es].”¹⁰⁶ Finally, CRAs often distinguished ratings based on the size of the issuer seeking ratings. Between 2004 and 2006, ratings agencies granted unduly favorable ratings to large issuers at a 10 percent higher clip as compared to smaller issuers.¹⁰⁷

As a result, CRAs often gave high investment ratings to CDOs that were largely filled with assets that were backed up by high-risk subprime mortgages.¹⁰⁸ Individuals who had invested in AAA-rated tranches, thought to provide the investor with excellent-risk protection, were in fact holding securities that left them incredibly vulnerable. The market for mortgage-backed securities, once created to decrease the cost of home financing, had quickly become a market overflowing with risk.

99. The three largest credit rating agencies are Standard & Poor’s, Moody’s, and Fitch. *Credit Rating*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/creditrating.asp> (last visited Apr. 24, 2017).

100. *Id.*

101. *Id.*

102. McConnell & Buser, *supra* note 23, at 175, 178.

103. *Id.* at 178.

104. *Id.* at 182.

105. Dean Baker, *The Housing Bubble and the Financial Crisis*, REAL-WORLD ECON. REV., no. 46, 2008, at 77.

106. *Id.* at 78.

107. Jie He, Jun Qian & Philip E. Strahan, *Credit Ratings and the Evolution of the Mortgage-backed Securities Market*, 101 AMERICAN ECON. REV., no. 3, 2011, at 131, 134.

108. Baker, *supra* note 105, at 78.

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III. The Financial Crisis of 2008

While the MBS market exploded during the early 2000s, the success of mortgage-backed securities experienced its demise in the late 2000s. Until 2006, the MBS market experienced growth not only due to the high volume of issuances,¹⁰⁹ but also because the United States housing market was thriving. As housing prices kept rising, subprime mortgage holders with inadequate sources of regular income could borrow against their rising home equity in order to make mortgage payments and avoid default.¹¹⁰ Towards the end of 2006, however, the United States housing market bubble created by excessive lending began to burst; housing prices began to fall and subprime mortgage holders living above their means could no longer avoid default. At the end of September 2007, about three percent of home loans were in the foreclosure process¹¹¹ and another seven percent of homeowners with a mortgage were at least one month past due on their payments.¹¹²

Subsection A delves into the housing bubble burst of 2007 and how it placed pressure on the financial services sector.¹¹³ Subsection B then discusses the aftermath of the MBS market crash and how the largest private-label MBS issuers struggled to stay afloat.¹¹⁴

A. The Housing Bubble Burst: The Beginning of the End

When the housing market is doing well, investing in MBS is a fairly safe bet. As long as mortgage holders keep up with payments, holders of MBS receive a stream of payments. But when the housing market begins to decline or interest rates rise, even the safest of these investments are in serious jeopardy. Rising interest rates reduce the value of mortgages. When borrowers default on mortgages, the stream of payments available to holders of MBS declines. “And when a firm [borrows] heavily to finance the purchase and trading of [MBS], it doesn’t take much of a fall in value to trigger serious problems.”¹¹⁵

While the housing market was strong through the 1990s and early 2000s, housing prices began to decline nationally by mid-2006, dropping by about 1.5

109. Total MBS issuances reached an all-time high of nearly \$3.2 trillion in 2003. Private-label issuances continued to increase and reached an all-time high of more than \$900 million in 2006. McConnell & Buser, *supra* note 23, at 179.

110. Havemann, *supra* note 3.

111. *Id.*

112. *Id.*

113. *See infra* Part III.A.

114. *See infra* Part III.B.

115. Chris Wilson, *What Is a Mortgage-Backed Security?*, SLATE (Mar. 17, 2008), http://www.slate.com/articles/news_and_politics/explainer/2008/03/what_is_a_mortgagebacked_security.html.

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percent by 2007.¹¹⁶ This price decline came at a time when interest rates increased as over two million homeowners faced the first interest-rate resets on their adjustable-rate mortgages.¹¹⁷ With default rates increasing, banks sought enforcement of repurchase agreements requiring lenders to buy back troubled mortgages.¹¹⁸ Additionally, the unexpectedly high default rates on subprime mortgages caused credit rating agencies to downgrade their ratings of MBS and CMOs.¹¹⁹

Financial institutions were forced to write down their MBS and CMO investments as their value became impaired. These write-downs forced firms to seek capital to meet regulatory requirements by selling unwanted mortgage-related assets.¹²⁰ Because so many firms were engaged in MBS issuance leading up to the housing market collapse, the market for selling these unwanted mortgage-related assets was illiquid, forcing firms to sell at a steep discount price.¹²¹ Raised fears regarding the creditworthiness of financial institutions ensued; this resulted in a run on the funding of banks—similar to what occurred in the Great Depression.¹²² Providers of capital withdrew both secured and unsecured funding from banks.¹²³ There was a massive impact on the financial services sector.¹²⁴

*B. Impact of the Crisis on the Financial Services Sector*¹²⁵

While the aftermath of the financial crisis hurt most Americans and stretched globally, it was especially harmful to issuers of mortgage-backed securities.¹²⁶ As was mentioned earlier, the popularity of MBS encouraged banks to set more lax credit requirements when providing mortgage loans in order to supply ever-eager MBS investors.¹²⁷ When the housing market crashed and homeowners defaulted on their

116. Jennifer E. Bethel et al., *Legal and Economic Issues in Litigation Arising from the 2007–08 Credit Crisis*, in *PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN* 163, 167 (Yasuyuki Fuchita, Richard J. Herring & Robert E. Litan eds., 2009).

117. *Id.*

118. See Carrick Mollenkamp et al., *Banks Go on Subprime Offensive*, WALL ST. J., Mar. 13, 2007, at A3.

119. Bethel et al., *supra* note 116, at 183. This led to a dramatic thinning in trading for subprime credit instruments, many of which carried synthetic, rather than market, values based on models because of the instruments' illiquidity." DiMartino & Duca, *supra* note 89, at 5–6.

120. Bethel et al., *supra* note 116, at 182–83.

121. *Id.* at 183–84.

122. *Id.*

123. *Id.*

124. See *supra* Part III.B.

125. For a detailed account of the Financial Crisis' impact on numerous financial institutions, see Havemann, *supra* note 3.

126. See *infra* Part III.A.i–III.A.iii.

127. *Mortgage-Backed Security (MBS)*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mbs.asp> (last visited Apr. 24, 2017). Individuals who possess good credit, make down payments, and have a steady stream of

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subprime mortgage loans,¹²⁸ issuers of subprime MBS and CMOs with tranches of subprime loans quickly realized these securities were overvalued.¹²⁹ Aside from the problems associated with CMO overvaluation discussed previously,¹³⁰ the use of special-purpose vehicles¹³¹ was also harmful due to the impact they had on security valuation.¹³² During the financial crisis, issuers of MBS realized that the MBS and CMOs held were not nearly as valuable as once thought.

While both agency and non-agency MBS issuers faced financial problems during the financial crisis, the largest issuers faced bankruptcy. In 2006, the MBS market was highly concentrated with the top five issuers accounting for 38% to 47% of all newly issued securities.¹³³ By 2009, all five of these issuers faced severe financial trouble.¹³⁴

The first of the five largest issuers to collapse was the top private MBS issuer in 2006,¹³⁵ Countrywide Financial Corporation.¹³⁶ Countrywide, which was founded in 1968 and had become the largest originator of single-family mortgages in the country by 1992,¹³⁷ possessed more than \$32.7 billion worth of pay-option adjustable-rate mortgages (“ARMs”), most of which were subprime.¹³⁸ By March 2007, 23.7% of their subprime mortgages were delinquent.¹³⁹ On August 23, 2007, Countrywide announced that Bank of America would invest \$2 billion to help out the mortgage

income typically receive prime mortgages. Mortgages given to those who fail to meet prime mortgage requirements are known as subprime or Alt-A mortgages. DiMartino & Buca, *supra* note 89, at 2.

128. “Subprime mortgages are extended to applicants deemed the least creditworthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risk and warrant the highest interest rates.” DiMartino & Buca, *supra* note 89, at 2.

129. *Mortgage-Backed Security (MBS)*, *supra* note 127.

130. *See supra* Part II.A.

131. A special-purpose vehicle/entity (“SPV”) is a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. An off-balance-sheet SPV documents its assets, liability, and equity on its own balance sheet rather than on the parent company’s balance sheet as equity or debt. *Special Purpose Vehicle/Entity – SPV/SPE*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/spv.asp> (last visited Apr. 24, 2017).

132. Financial lenders preferred utilizing SPVs because their use allegedly placed lower risks on the lender and also led to higher credit ratings for securities issued. *Id.*

133. He et al., *supra* note 107, at 133. The top five issuers in 2006 were Countrywide, General Motors, Bear Stearns, Lehman Brothers, and IndyMac. *Id.*

134. *Timeline: Key events in financial crisis*, USA TODAY, <https://www.usatoday.com/story/money/business/2013/09/08/chronology-2008-financial-crisis-lehman/2779515/> (last modified Sep. 9, 2013).

135. He et al., *supra* note 107, at 133.

136. Havemann, *supra* note 3.

137. Scott Olster, *How the roof fell in on Countrywide*, FORTUNE (Dec. 23, 2010), <http://fortune.com/2010/12/23/how-the-roof-fell-in-on-countrywide/> (citing BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS (2011)).

138. *Id.*

139. *Id.*

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giant.¹⁴⁰ However, the large loan given by Bank of America was not enough for Countrywide to survive; in January 2008, Bank of America was able to purchase Countrywide for only \$4 billion.¹⁴¹

Other financial institutions like Lehman Brothers and Bear Stearns¹⁴² weren't as lucky. During the housing boom in 2003 and 2004, Lehman acquired five mortgage lenders, including subprime lender BNC Mortgage and Aurora Loan Services, which specialized in Alt-A loans.¹⁴³ This led to Lehman securitizing \$146 billion in mortgages during 2006, a 10% increase over the previous year.¹⁴⁴ However, as the housing market began to collapse in 2007, so did Lehman's stock price.¹⁴⁵ Stocks continued to fall throughout 2008, and coupled with Korea Development Bank's failure to purchase a stake in the bank,¹⁴⁶ Lehman was forced to declare bankruptcy on September 15, 2008.¹⁴⁷

As the MBS market dwindled and losses piled up as institutional investors attempted to unload bad MBS investments, the United States government was forced to make a decision. With the potential collapse of General Motors,¹⁴⁸ the government initiated a plan to bail out the financial services sector. The U.S. Treasury stepped in with the \$700 billion bailout to mitigate the credit crunch, but it was the Federal Reserve that led the charge on creating a market for unloading MBS.¹⁴⁹ "The Federal Reserve bought \$1.75 trillion in MBS directly while the Troubled Asset Relief Program (TARP) injected capital into banks."¹⁵⁰ The crisis passed, but the total government commitment, implicit and explicit, was significantly larger than the \$700 billion figure often reported.¹⁵¹

140. *Id.*

141. Havemann, *supra* note 3.

142. Bear Stearns had a thick portfolio of MBS and when the value of those securities plummeted, Bear Stearns was rescued from bankruptcy by JPMorgan Chase. The agreement was for \$10/share, with the Federal Reserve agreeing to absorb up to \$30 billion of Bear's declining assets. *Id.*

143. *Case Study: The Collapse of Lehman Brothers*, INVESTOPEDIA, <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp> (last modified Feb. 16, 2017).

144. *Id.*

145. *Id.*

146. Lehman stayed afloat thanks in large part to the hefty investment of \$2 billion made by the Korean Development Bank. *Id.* However, the Korean Development Bank's refused to take on anything more, especially in terms of management. *Id.*

147. *Id.*

148. General Motors filed its application for Chapter 11 bankruptcy on June 1, 2009. *The Bankruptcy of General Motors: A Giant Falls*, ECONOMIST (June 4, 2009), <http://www.economist.com/node/13782942>.

149. *Mortgage-Backed Securities (MBS)*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/mbs.asp> (last visited Apr. 24, 2017).

150. *Id.*

151. *Id.*

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IV. The Legal Aftermath of the Financial Crisis

Beginning shortly after the burst of the Internet bubble in the early 2000s, courts began to see an increasing number of big-ticket securities cases¹⁵² that were intensely litigated, received publicity, and progressed far beyond the initial stages of litigation.¹⁵³ These cases were typically “stock-drop” cases, brought by a class¹⁵⁴ of shareholders who alleged “that the defendant corporation had experienced a decline in its share price after it was revealed that the corporation had allegedly made prior misrepresentations or fraudulent statements.”¹⁵⁵

Following the failure of numerous financial institutions like Lehman Brothers and Bear Stearns, securities litigation shifted from targeting loan originators to targeting defendants involved in loan securitization.¹⁵⁶ Initially, courts began to see a dramatic increase in the number of securities class action suits, namely stock-drop cases.¹⁵⁷ Because of the write-downs of financial institutions,¹⁵⁸ there was a significant rise in the number of securities class actions against a variety of participants in the market for subprime MBS and the complex derivative investments that sprung from that market.¹⁵⁹ Most litigation has centered on whether investments were valued appropriately by the financial institutions that held them.¹⁶⁰ Shareholders claimed that the devaluation of MBS and CMOs was effectively caused by misrepresentation, and sought to recover following the drop of stock prices of major financial institutions that held MBS and CMOs.¹⁶¹ However, the initial increase in securities litigation claims did not last long due to a number of appellate court decisions.

152. “Big-ticket” cases are those in which the damages sought far exceed any available liability insurance, where early settlement is rare. Daniel Slifkin, *The Changing Landscape of Securities Litigation*, NEW DEVELOPMENTS IN SECURITIES LITIGATION 2 (2014).

153. *Id.*

154. Stock-drop cases were usually security class action filings. Kathleen N. Massey, *Securities Litigation Arising Out of the Financial Crisis: A Survey of Relevant Decisions and Their Implications*, 16 THE INV. LAW., no. 6, May 2009, at 2.

155. Slifkin, *supra* note 152, at 2.

156. Christopher J. Miller, “Don’t Blame Me, Blame the Financial Crisis”: A Survey of Dismissal Rulings in 10b-5 Suits for Subprime Securities Losses, 80 FORDHAM L. REV. 273, 290 (2011).

157. According to recent reports, the number of securities class actions filed in 2008 was at its highest level since 2004, and there were at least 576 cases filed in 2008 relating to subprime mortgages and related issues. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS—2008: A YEAR IN REVIEW (2009), <http://securities.cornerstone.com/pdfs/YIR2008.pdf>; GRACE LAMONT & PATRICIA A. ETZOLD, PRICEWATERHOUSECOOPERS 2008 SECURITIES LITIGATION STUDY (2009); JEFF NIELSEN ET AL., SUBPRIME MORTGAGE AND RELATED LITIGATION – 2008: SEEKING RELIEF (2009), http://www.navigantconsulting.com/downloads/knowledge_center/Navigant_2008_Credit_Crisis_Litigation_Report_Exec_Summary_Mar-09.pdf.

158. See DiMartino & Duca, *supra* note 89, at 2.

159. James C. Dugan, *A Primer on Securities Litigation and Enforcement in an Economic Crisis*, SECURITIES LITIGATION AND THE ECONOMIC CRISIS 5–6 (2009).

160. *Id.* at 6.

161. Slifkin, *supra* note 152, at 2–3.

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In *Dura Pharmaceuticals, Inc. v. Broudo*,¹⁶² the Supreme Court formalized the requirement that misrepresentations must be the proximate cause of a plaintiff's loss under Rule 10b-5.¹⁶³ In reviewing the Ninth Circuit's decision, the Court reasoned that while purchasing a security at a price inflated by a misrepresentation, such as a MBS given a faulty AAA rating by a CRA, might lead to a later loss, it is far from invariably so.¹⁶⁴ Rather, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances [or] changed investor expectations . . . which taken separately or together account for some or all of that lower price."¹⁶⁵

In *Lentell v. Merrill Lynch & Co.*,¹⁶⁶ the Second Circuit delved further into the effect a non-fraud explanation might have on pleading loss causation.¹⁶⁷ Establishing a two-part test for pleading loss causation, the court emphasized that proximate causation in securities fraud suits differs from causation in other torts because the loss is not directly caused by the defendant, but by the underlying circumstance that is concealed or misstated.¹⁶⁸ The Second Circuit held that a plaintiff must plead "both that the loss be foreseeable and that the loss be caused by the materialization of the concealed risk."¹⁶⁹ It also noted that if a plaintiff's loss "coincides with a market-wide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases."¹⁷⁰

Finally, in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,¹⁷¹ the Supreme Court discussed the *scienter* requirement in securities fraud claims.¹⁷² In *Tellabs*, the Court held that the failure of defendant corporations to predict events that eventually contribute to the realization of losses does not constitute fraud.¹⁷³ In the absence of allegations that the defendant's actions were reckless in not perceiving these risks at the time they made their disclosures, plaintiffs did not adequately allege *scienter*.¹⁷⁴

Based on the aforementioned appellate court decisions, the number of securities claims brought by class actions has decreased since 2009.¹⁷⁵ Instead,

162. 544 U.S. 336 (2005).

163. Miller, *supra* note 156, at 285.

164. *Dura*, 544 U.S. at 336–8.

165. *Id.* at 343.

166. 396 F.3d 161 (2d Cir. 2006).

167. Miller, *supra* note 156, at 286.

168. *Lentell*, 396 F.3d at 173.

169. *Id.*

170. *Id.* at 174 (quoting *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994)).

171. 551 U.S. 308 (2007).

172. *Scienter* is a mental state in fraud that is characterized by an intent to deceive, manipulate, or defraud. *Scienter*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/legal/scienter> (last accessed Apr. 24, 2017).

173. *Tellabs*, 551 U.S. at 320 (citing *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978)).

174. *Id.*

175. Slifkin, *supra* note 152, at 2.

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sophisticated individual plaintiffs have brought the majority of claims relating to the financial crisis.¹⁷⁶ Based on *Dura* and *Lentell*, plaintiffs are now required to remove market movement from the equation and show a causal link between misrepresentations made by a financial institution and the alleged decrease in stock price.¹⁷⁷ Because of *Tellabs*, plaintiffs must demonstrate that the defendant corporations were reckless in failing to recognize the risks associated with MBS and CMOs; “an inference of *scienter* must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.”¹⁷⁸ However, the subprime crisis “has not easily lent itself to fraud, mainly because the assets that are at the heart of these cases tend to be complex and difficult to value.”¹⁷⁹ As such, investors of MBS are typically institutional investors and use MBS to obtain higher yields than government bonds, as well as to provide a way to diversify their portfolios.¹⁸⁰ Additionally, the unprecedented scale of the crisis¹⁸¹ and the uniformity of the decline in the value of MBS investments make it difficult for plaintiffs to prove their losses were a result of misrepresentation, as opposed to general market conditions.¹⁸² Finally, it is difficult to form a class when bringing a claim regarding MBS because each mortgage pool in an MBS is unique – every mortgage is distinct in some way.¹⁸³ For these reasons, class action suits regarding the financial crisis have steadily declined since the initial uptick in claims in 2007, and most claims are no longer brought by sophisticated plaintiffs in their individual capacity.

V. Conclusion

The financial crisis of 2008 impacted billions worldwide, especially the U.S. financial sector and the American working class. The issuance of mortgage-backed securities, while meant to provide banks with the ability to help financially stable individuals with home financing, was taken advantage of by private-label issuers.¹⁸⁴ Innovations within the mortgage market heightened the risk associated with MBS, and credit rating agencies failed to effectively value such securities.¹⁸⁵ When the housing market

176. *Id.* at 1, 7.

177. *Id.* at 3.

178. *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 314 (2007).

179. Dugan, *supra* note 159, at 6.

180. Alexandra Yan, *Introduction to Asset-Backed and Mortgage-Backed Securities*, INVESTOPEDIA, <http://www.investopedia.com/articles/bonds/12/introduction-asset-backed-securities.asp> (last visited April 24, 2017).

181. By the middle of 2009, the financial crisis had resulted in write-down losses exceeding \$135 billion across a range of financial institutions. Dugan, *supra* note 159, at 6–7.

182. *Id.* at 7.

183. Slifkin, *supra* note 152, at 4.

184. *See supra* Part II.B.

185. *Id.*

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collapsed in 2006, these risks and failures became apparent. The failures made by financial institutions led some to close their doors, while others became dependent on other institutions or the U.S. government.¹⁸⁶ Aside from the economic impact of MBS, the landscape of securities litigation changed.¹⁸⁷ Only time will tell what additional effects the use of mortgage-backed securities prior to 2008 will have on both the economy and the court system. All we know is that the securitization of residential mortgages by financial institutions was a chief culprit of the Financial Crisis of 2008.

186. *See supra* Part III.B.

187. *See supra* Part IV.