Residential Mortgage Loan Sales and Repurchases

Accounting, Disclosure, Control Issues, and Risks
Relating to Sellers' Representations and Warranties

***** An Update For First Quarter 2012 10-Q Filings and Recent Developments *****

Article #8 in a series beginning 3rd Quarter 2010. For copies of this and previous articles go to:
www.natomapartners.com

By: Robert L. Christensen

Date: May 18, 2012

1st Quarter 2012 - More of the Same

This series of articles, which began in November 2010, has analyzed the issues related to residential mortgage loans sales and repurchases. It focuses primarily on the accounting for representations and warranties given by the loan sellers. What I have found is that the reserves required for repurchases of loans that did not meet the representations and warranties have been consistently and massively underestimated. As the numbers in the adjacent column indicate, for the four largest US banks, the first quarter of 2012 continues the trend of underestimation. This is particularly apparent in the quarterly provisions shown in Table B. These provisions have actually increased from each of the prior two quarters for all of the banks except for JPMorgan Chase (JPMC). However, as noted in previous articles, much of the reserve for JPMC is actually recorded in the legal reserve. The legal expense for the quarter (see page 2) was $2.5 billion "predominately for mortgage-related matters." So I can definitively continue to say that, at least through March 31, 2012, all of the banks are still trying to "catch up" in recording reserves that should have been recorded at the time the loans were sold, which was mostly the period 2005-2008.

Regulatory Developments - Mostly Disappointing

In my last article dated February 29, 2012, I mentioned that the "wheels of justice grind slowly". I also promised to report back to you with an evaluation of actions by the regulators, as they unfold. For the most part, it is not a pretty picture. Here are some highlights and lowlights:

(Continued on page 3)

The Reported Numbers through March 31, 2012

The provisions for losses on loan repurchases by the four largest sellers have grown from $5 billion in 2009, to $12 billion in 2010, to $19 billion in 2011, and are almost $1.4 billion for the current quarter. These are reported (in $ millions) as follows:

Table A: Provisions - Annual & Current Year-To-Date

	2008	2009	2010	2011	**2012 (Q1)**
BofA	246	1,851	6,786	15,611	**287**
JPMC	1,233	1,865	3,003	1,535	**323**
Wells	399	927	1,618	1,285	**430**
Citi	n/a	525	933	968	**341**
	1,878+	5,168	12,340	19,399	**1,381**

The provisions for the last six quarters are reported (in $ millions) as follows:

Table B: Provisions - Quarterly

	2010 (Q4)	2011 (Q1)	2011 (Q2)	2011 (Q3)	2011 (Q4)	**2012 (Q1)**
BofA	4,148	1,020	14,040	281	270	**287**
JPMC	349	420	398	314	403	**323**
Wells	464	249	242	390	404	**430**
Citi	252	126	228	301	312	**341**
	5,213	1,815	14,908	1,286	1,389	**1,381**

The reserves have consistently been underestimated since 2006 and have significantly increased since 2008. The repurchase reserves for these sellers skyrocketed to $21.9 billion at year-end 2011 and have only slightly increased to just over $22 billion at March 31, 2012. They are reported (in $ millions) as follows:

Table C: Reserves - End of Period

	2009	2010	2011	**2012 (Q1)**
BofA	3,507	5,438	15,858	**15,746**
JPMC	1,705	3,285	3,557	**3,516**
Wells	1,033	1,289	1,326	**1,444**
Citi	482	969	1,188	**1,376**
	6,727	10,981	21,929	**22,082**

From: Naked Capitalism blog March 12, 2012

"[the administration] has also refused to use the best weapon in its arsenal: Sarbanes Oxley, which would allow it to file civil and from that if successful, criminal charges for false certifications about the adequacy of internal controls, in particular, risk controls."
http://www.nakedcapitalism.com/2012/03/the-legal-lie-at-the-heart-of-the-8-5-billion-bank-of-america-and-federalstate-mortgage-settlements.html

What are the Disclosures from the First Quarter 2012 Earnings Releases & 10-Qs?

Bank of America

- Provided $287 million for reps and warranties reserve.
- The range of additional possible losses in excess of current reserves is unchanged at $5 billion. All $5 billion is related to private label exposures. BofA is unable to estimate possible losses in excess of reserves for GSE's.
- The 10-Q re-iterates that repurchase reserves and the range of additional possible losses do not include amounts that could be required if or for the:
  - ✓ BNY Mellon Settlement is not approved.
  - ✓ FNMA's recently asserted position that mortgage insurance rescissions are automatically a breach of reps and warranties.
  - ✓ Future evolution of GSE's who recently are much more aggressive on repurchase requests and resolution processes.
  - ✓ Monoline insurers' claims where the bank believes a valid defect has not been identified or any future claims by the insurers.
  - ✓ Servicing related claims.
  - ✓ Litigation developments (see below).
- Total outstanding claims increased significantly to $16.0 billion from $12.7 billion as of Q4 2011.
- Sensitivity of the reserve to a simultaneous 10% increase or decrease of estimated defaults, loss severity, and net repurchase rate would increase or decrease the liability by $850 million or $800 million, respectively. (As the 10-Q does not update these amounts from the 2011 10-K, we should be able to assume they have not changed significantly.)
- Each 1% change in home price estimates would change the liability by $125 million. (As the 10-Q does not update this amount from the 2011 10-K, we should be able to assume it has not changed significantly.)
- Litigation developments:
  - ✓ Litigation expense (excludes expenses of internal and external service providers) was $793 million in Q1 2012 compared to $940 million in Q1 2011. (Annual expense had increased to $5.6 billion in 2011 from $2.6 billion in 2010.) Additional "reasonably possible losses" disclosed as of 3/31/12 increased to up to $4.2 billion from up to $3.9 billion at 2011 year end. No breakdown of how these amounts relate to mortgage issues is disclosed, but I believe it reasonable to speculate that it is a significant portion.
  - ✓ The significant number of cases relating to mortgage-backed securities continue with no dramatic developments or new cases disclosed in the 10-Q.
  - ✓ The previously proposed foreclosure settlement which includes a $1.9 billion cash payment, $7.6 billion of borrower assistance, and $1.0 billion of refinancing assistance and FHA settlement to pay $500 million upfront and as much as $500 million more in three years were signed on April 5, 2012. The required cash payments of $2.4 billion were made in April 2012.

JPMorgan Chase & Co.

- Provided $323 million for repurchase liabilities. Down from $403 million in Q4 and from the $384 million average of the previous 4 quarters.
- Outstanding repurchase demands increased to $3.5 billion from $3.3 billion in the prior quarter and $2.4 billion in Q1 last year.
- Repurchase demands include private label demands, but reserves for private label securities have not been included in repurchase reserves. They remain in litigation reserves, the amount of which is not disclosed.
- JPMC is unchanged at up to $2.0 billion of "reasonably possible losses" in excess of the $3.5 billion already recorded in the repurchase reserve.
- Litigation expense was $2.5 billion in Q1 2012 compared to $4.9 billion in all of 2011 and $7.4 billion in 2010 and $161 million in 2009. This quarter's expenses are described as "predominately for mortgage-related matters." This is consistent with prior years' disclosures which have indicated significant amounts of litigation expenses relate to reserves for mortgage related matters including repurchase exposures on private label securities. However, those amounts have not specifically been broken out and the total legal reserve for private label loan sales has never been disclosed.
- Based on past comments from Jaime Dimon (CEO) as well as analyst and press estimates, the litigation reserves for private label securitization issues could be $10 billion or more, but unfortunately we can only guess.
- Repurchase demands do not include amounts related to WAMU, which JPMC maintains are the responsibility of the FDIC. The FDIC may not agree. However, JPMC disclosed that the current repurchase liability includes $32 million (compared to $173 million last quarter) for <u>future</u> demands relating to loans sold by WAMU to the GSE's.
- The previously proposed foreclosure settlement which includes a $1.1 billion cash payment, $3.7 billion of borrower assistance, and $500 million of refinancing assistance became effective on April 5, 2012.

What are the Disclosures from the First Quarter 2012 Earnings Releases & 10-Qs? (continued)

- Provided $341 million for the repurchase reserve, which is the fourth consecutive quarterly increase.
- Repurchase claims for Q1 2012 increased to $1.3 billion from $747 million in Q4 2011 and $891 million in Q1 2011. Unresolved claims increased to $2.0 billion at the end of Q1 2012 from $1.5 billion at year end 2011.
- Citi continues to state that it does not have sufficient information to estimate a range of "reasonably possible losses" in excess of the amount reserved for repurchases.
- Sensitivity of the reserve to a simultaneous 10% adverse change in future loan documentation requests, repurchase claims as a percentage of loan documentation requests, claims appeal success rate, and loss severity would increase the liability by $602 million vs. $620 million last quarter.
- The previously proposed foreclosure settlement which includes a $415 million cash payment, $1.4 billion of borrower assistance, and $378 million of refinancing assistance was approved by the court on April 4, 2012.

- Provided $430 million for the reps and warranties reserve, which remains elevated compared to the first 2 quarters of 2011.
- Outstanding repurchase claims declined to $1.9 billion from $2.0 billion last quarter and from a peak of $4.3 billion in Q2 2010.
- Wells disclosed up to $2.3 billion (vs. $2.1 billion last quarter and $1.9 billion Q3 2001) of "reasonably possible losses" in excess of the $1.4 billion already recorded in the repurchase reserve.
- Sensitivity of the reserve to a 10% and 25% increase in loss severity is a $133 million and $333 million increase, respectively. The same percentage increases in the repurchase rate are a $122 million and $304 million increase, respectively. (As the 10-Q does not update these amounts from the 2011 10-K, we should be able to assume they have not changed significantly.)
- The previously proposed foreclosure settlement which includes a $1.0 billion cash payment, $3.4 billion of borrower assistance, and $900 million of refinancing assistance became effective on April 5, 2012. The required cash payments of $1.0 billion were made in April 2012.

Regulatory Developments—Mostly Disappointing *(Continued from page 1)*

- The Department of Justice Residential Mortgage-Backed Securities Working Group formed in January 2012 and chaired by NY AG Schneiderman has begun to receive significant public criticism. Schneiderman is clearly feeling the heat. On April 26th in an op-ed piece in the New York Daily News, he reaffirmed his commitment and priority to this initiative. He also indicated that the settlement "is not the end" but rather "it's a down payment". However, this Working Group as currently constituted has simply not yet established that it is credible. Consider the following:
  - ✓ It consists of 50-60 people. (I do not believe there is a definitive number from an official source.) Whatever the exact number is, it appears that these employees are not primarily new hires. Rather, they are current government employees already working on cases related to the financial crisis.
  - ✓ Compare this to the 1000+ people assembled during the savings & loan (S&L) crisis of the 1980's and the 100+ people dedicated to the Enron cases.
  - ✓ It has not hired an executive director. It has no office, no telephones and no website.
  - ✓ They have requested a $55 million appropriation from Congress. Good luck with that! And, in the unlikely event that they get the money, it is a pitifully small amount.

  This Working Group seems to be more of a public relations effort to make it look like something is being done. We will undoubtedly see headlines about settlements attributed to the Working Group. For instance, on May 10, a settlement of $202 million was reached with Deutsche Bank for mortgage related HUD-FHA violations. The press release noted that the US Attorneys who brought the case worked "in coordination with President Barack Obama's Financial Fraud Enforcement Task Force." But the case was filed in May 2011, predating the formation of the Working Group by many months.

Absent significant public or political pressure, the Working Group will likely remain more of a "Potemkin village" than the tough prosecution unit it has been portrayed as being. ***(Continued on page 4)***

Regulatory Developments—Mostly Disappointing *(Continued from page 3)*

- The Office of Mortgage Settlement Oversight (OMSO) was officially established on April 4, 2012 as the "Monitor" to oversee the compliance of the $25 billion settlement with 49 state AGs and the federal government. The responsibilities of the Monitor as described in the various consent orders signed by the four largest banks (plus Ally Financial) are important. However, I believe the near and mid-term requirements of the orders are unlikely to be met. A recent article in MReport.com on April 25, 2012 states that, to date, the help of one full-time staff member has been retained, plus six other part-timers. A letter was sent out to 40 companies to see if they were interested in becoming the "Primary Professional Firm" which the orders call for to do the detailed work of the Monitor. The orders lay out very extensive independence standards for the Primary Professional Firm to meet. These include future limitations on the firm and the firm's individual's ability to work for the institutions monitored. It is very hard for me to see what firms will have the required skills and resources and also meet the independence rules.
- The Consent Orders signed by the OCC and other regulators in April 2011 relating to foreclosure abuses had deadlines which have not been met. The deadlines have been extended. The banks and their "independent consultants" are having difficulty finding people injured in the foreclosure process in order to compensate them as required under the agreements.
- The SEC website cites these "key statistics" as of April 24, 2012 for enforcement actions related to the "financial crisis":
    - ✓ Number of Entities and Individuals Charged - 102
    - ✓ Number of CEOs, CFOs, and Other Senior Corporate Officers Charged - 55
    - ✓ Number of Individuals Who Have Received Officer and Director Bars, Industry Bars, or Commission Suspensions - 25
    - ✓ Penalties Ordered or Agreed To - $1.25+ billion
    - ✓ Disgorgement and Prejudgment Interest Ordered or Agreed To - $413+ million
    - ✓ Additional Monetary Relief Obtained for Harmed Investors - $355+
    - ✓ Total Penalties, Disgorgement, and Other Monetary Relief - $2+ billion

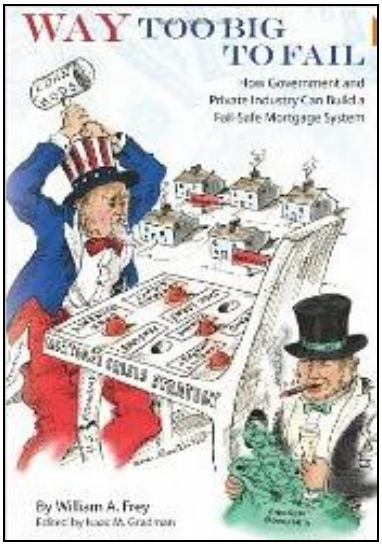
  These statistics are miniscule as compared to the ***trillions*** of dollars of losses related to the financial crisis. Of the over 100 charged in civil cases only a handful has been referred to the Justice Department for criminal prosecution. The S&L crisis saw over 1000 bankers actually go to prison. Keep in mind that the S&L crisis was significantly smaller than the current financial crisis.
- On January 31, 2012, banking regulators released *Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties.* Among other things, this guidance requires banks who hold loans secured by junior liens where the related loan backed by a senior lien is 90 days past due to place its loan on nonaccrual status even if that loan is currently performing. This resulted in the following amounts being reclassified as nonaccrual: BofA - $1.9 billion, JPMC - $1.6 billion, Wells - $1.7 billion, and Citi - $0.8 billion.

  All four banks stated that this had no material effect on the allowance for loan losses on these loans as they had already been considering the performance of the associated first mortgage loan in determining the allowance. In many cases the bank had sold or securitized the first lien loans in question and was continuing to service them. Associated loans secured by the junior loans were often not sold and remain on the banks' balance sheets. Many observers noting the difference between the junior lien loans market value and the banks carrying value have warned that allowances are inadequate. The banks have vehemently denied this. Given the banks record on estimating their repurchase reserves, this situation certainly bears watching.
- As noted in previous articles, the massive misestimating of repurchase reserves and related internal control weaknesses and disclosure issues have been associated with financial statements which received clean audit and internal control reports from the banks' auditors. To date we are not aware of any auditors being subject to enforcement actions from their regulator—the Public Company Accounting Oversight Board, relating to these issues. This may be happening behind the scenes, as enforcement actions do not become public until a final resolution has occurred.

Note: I will continue to follow regulatory developments on accounting, disclosure, control issues, and risks relating to sellers' representations and warranties and report on them in future updates, as warranted.

Recommended Reading:

I have just completed reading the book "**WAY Too Big To Fail: How Government and Private Industry Can Build a Fail-Safe Mortgage System"**. This book by William A. Frey, edited by Isaac M. Gradman, and published by Greenwich Financial Press provides not only an excellent primer on the various parties involved in mortgage backed securities, but perhaps more importantly the many inherent conflicts of interest among these parties, at times within the same organization. The book goes beyond describing the mortgage debacle, and has interesting and thought provoking recommendations on how the system should be reformed, as well. I highly recommend it.



About The Author:

Bob Christensen is the author of this article and an authority on the auditing, accounting, disclosure, control and risk issues relating to residential mortgage loans sold with representations and warranties. He was an auditor for 24 years with Arthur Andersen, Partner in charge of the Western Region Financial Services practice and a member of the US-wide Financial Services Leadership Team. After Andersen, Bob co-founded Protiviti, a premier risk consulting and internal audit firm.

Bob now provides expert services on cases that deal with accounting and auditing matters within the financial services industry and is a senior advisor to Natoma Partners. He has provided expert consulting services and advice to the Enforcement Division of the Public Company Accounting Oversight Board. These expert services focused on audit and accounting issues including audit planning and documentation, internal controls, transfers of financial assets, reserves for representations and warranties, allowance for loan losses, and lower of cost or market valuations. He is also currently providing expert services to a law firm representing a major US bank on the accounting of allowance for loan losses and related internal control and disclosure issues.

Bob is a Certified Public Accountant. He has a Bachelor of Arts in Philosophy from Reed College and a Masters of Business Administration from the University of Wisconsin.

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Select Articles and News Reports - March/April/May 2012:

Press releases, articles, blogs, and other publically available materials on this topic are being issued on a daily basis. The period since our last article, dated February 29, 2012, has been a busy one. There are many streams of activity underway that relate to our topic and the volume of material available will, I believe, continue to grow. New streams may be added. For example (as I have noted in previous articles), there has still been no significant frontal assaults challenging the banks' basic accounting or asserting that material weaknesses in internal control went unreported. The related audits have also largely escaped public scrutiny. This appendix presents a selection of recent publications that I found to be relevant to the issues I have discussed in my articles and that I also found interesting. The selection covers an array of issues related to residential mortgages including: continued lawsuits - with trustees and additional investors entering the game, settlements and associated monitoring activities, ongoing matters with repurchase activities, loan reviews, foreclosures, regulatory developments, and more.

I have made brief comments on a few of the articles in ***bold type*** preceded by ***RLC***.

American Banker – March 5, 2012 - The Little We Know About Foreclosure Reviews Is Troubling. The good news: regulators are pulling back the curtain on the consultants that the big mortgage servicers hired, under orders from the agencies, to review their foreclosure processes. The bad news: what's been revealed isn't pretty … the Federal Reserve Board posted engagement letters for servicers … part of the problem is that many of the reviews are being done by Big Four auditing firms … conflicts of interest here are egregious – in spite of claims by the OCC and Fed that they rejected some auditor-servicer engagements because of conflicts. **RLC--This is hardly surprising since the firms with the capabilities and resources to perform this work were bound to have some conflicts of interest. Most of these banks, while perhaps not current clients, would certainly be attractive future clients. See also my comments on independence following the March 19 and April 3 Wall Street Journal articles below.**

Wall Street Journal – March 15, 2012 - Banks Take More Hits on Bad Loans. A problem that bankers hoped was behind them—rising costs to repurchase soured home loans they previously sold to the government-backed mortgage investors Fannie Mae and Freddie Mac—has instead bitten back with a vengeance. Fannie and Freddie asked banks to buy back $33 billion of loans last year. That is up 10% from 2010, according to federal securities filings the companies have made this month**. RLC—More than half ($17.5 billion) of these buyback requests in 2011 were made to BofA.**

Wall Street Journal - March 19, 2012 - Fed Plans to Fine Eight More Banks for Foreclosure. The Federal Reserve will fine eight more banks that have been subject to scrutiny amid allegations of improper foreclosure practices, adding to the list of the nation's five largest mortgage servicing firms penalized last month. Federal and state officials last month announced a $25 billion settlement of foreclosure-abuse allegations with the nation's five largest mortgage servicing firms … Suzanne G. Killian, senior associate director of the Fed's division of consumer and community affairs, said that eight more institutions will be fined, these being: HSBC Holdings PLC's U.S. bank division, SunTrust Banks Inc., MetLife Inc., U.S. Bancorp, PNC Financial Services Group Inc., EverBank, OneWest Bank and Goldman Sachs Group Inc. **RLC—If these banks are subject to similar requirements as those who already signed consent orders, it will mean more work for the "Primary Professional Firm" not yet hired by the Monitor.**

Bloomberg – April 2, 2012 - JPMorgan Sued Over $402 Million in Mortgage Securities. JPM was sued by DZ Bank over allegations the bank made false and misleading statements in selling residential mortgage-backed securities. The lawsuit, filed March 30, seeks $402 million in damages, according to a court filing. The complaint was the second filed this year by DZ Bank against JPM, previously saying it bought $85 million worth of the securities based on flawed offering materials. DZ Bank has also sued HSBC Holdings Plc, over $122 million worth of the investments.

Bloomberg – April 2, 2012 - Bank of America Sued in N.Y. Over Mortgage-Backed Securities. BAC was sued by Bank Hapoalim BM (POLI) and Principal Life Insurance Co. for fraud and breach of contract over the sale of almost $960 million worth of mortgage-backed securities. Principal Life sued over its investment in $239 million worth of the securities. Principal Life had sued JPM earlier this month [in a similar case] for over $114.9 million. Bank Hapoalim, Israel's second-biggest bank by assets, sued for over $721 million. **RLC - Bank of America did not disclose this new litigation in their March 31, 2012 10-Q. Apparently, this subsequent event was not considered material.**

Financial Times – April 3, 2012 - HSH Sues Barclays Over Mortgage Securities. German bank HSH Nordbank allege Barclays "knew or were reckless" in not knowing that mortgage loans were not properly transferred to the trusts at the time the mortgage-backed security was marketed and sold to investors … [and] misrepresented the credit quality of the loans and that they failed to meet underwriting standards in the mortgage securities.

New York Times (Dealbook) - April 3, 2012 - Review Finds Possible Flaws in More Than 138,000 Bank Foreclosures. An independent review has flagged thousands of cases for possible flaws in the foreclosure process at the nation's largest mortgage servicers. Independent consultants on behalf of the Office of the Comptroller of the Currency — flagged more than 138,000 cases for possible flaws in the foreclosure process at the nation's largest mortgage servicers. The review is part of a broader crackdown by regulators on sloppy, inaccurate documents used in foreclosure proceedings. Separately, consumers who believe that they have suffered financial injury as a result of wrongful foreclosures have until July 31 to request an independent review of their cases. So far, 136,276 customers have requested such a review.

Wall Street Journal – April 3, 2012 - Just 3% of Eligible Borrowers Apply for Foreclosure Review. Last April, federal banking regulators cracked down on alleged foreclosure abuses by announcing enforcement actions against 14 major financial companies and promising widespread reforms. A year later, borrowers haven't received any compensation from banks, officials haven't agreed on penalties for errors ranging from incorrect credit-bureau reporting to wrongful foreclosure, and millions of invitations to start foreclosure reviews have received no response. So far, just 3% of borrowers have applied for the foreclosure reviews specified in last April's consent orders. The post office has returned the banks' own foreclosure-related mailings as undeliverable at almost twice that rate. At least one bank is struggling to get systems in place for handling and testing borrower responses. Some people familiar with the process said the amount being spent on foreclosure reviews could far outweigh the amount provided to consumers in compensation. Three major banks are spending close to $50 million a month each on auditors, attorneys and other costs related to the review process, said one person familiar with the banks' efforts. **RLC – During the Enron crisis, Arthur Andersen's independence was questioned because they were earning fees of $50 million per year from Enron. $50 million of fees per month is a staggering amount! Given the missed deadlines that have already occurred and the magnitude of the tasks involved, these engagements can expect to go on for many more months.**

Office of Mortgage Settlement Oversight – April 5, 2012 – Mortgage Settlement Monitor Begins Work. Joseph A. Smith, Jr. today officially assumed his position as the monitor of the mortgage servicing settlement among 49 states, the federal government and five major banks. In this role, Smith will work to ensure that the banks follow the requirements outlined in the settlement agreement. Today also marks the formal creation of the Office of Mortgage Settlement Oversight (OMSO), the body Smith has set up to facilitate his work. Smith will receive periodic reports from the settlement participants and oversee bank compliance with the agreement. The Monitor is empowered to work with noncompliant institutions to establish corrective plans, or, if necessary, to recommend penalties or to seek injunctive relief to enforce the settlement. **RLC – my initial read of the associated consent orders agreed to by the banks tells me that initial deadlines may not be achievable. In addition, how will they find a "primary professional firm" as to help with this oversight that does not have independence conflicts? See OCCs dismissal of consultant Allonhill from Aurora Bank - American Banker, May 11, 2011, further below.**

United Press International (UPI.com) - April 9, 2012 - Mortgage Litigation Sets a Record. Some 244 lawsuits were tracked in Mortgage Daily's fourth-quarter 2011 Mortgage Litigation Index the highest number since the index's 2007 launch. Foreclosure cases dominated quarterly mortgage litigation activity and show no sign of relenting. Case count jumped from 218 in the third quarter and 151 in the fourth-quarter 2010. "Unfortunately, the phenomena that led to the surge in litigation in the fourth quarter of 2011 have only intensified in 2012, suggesting that we are unlikely to see a significant decline in litigation in the near term," Christopher Willis, a partner at Ballard Spahr LLP, who prepared an analysis of the data.

New York Times (DealBook) - April 10, 2012 - Mortgage Servicers Face New Oversight. The Consumer Financial Protection Bureau on Tuesday outlined preliminary plans to address a lack of transparency and accountability among mortgage servicers. The new scrutiny will take aim at the industry's aggressive tactics and sloppy record keeping that bedeviled homeowners in the aftermath of the financial crisis. Richard Cordray, director of bureau, said the new regulation would mandate "clear" monthly mortgage statements that break down a homeowner's obligations by principal, interest, fees and the due date of the next payment. **RLC—How many regulators does it take to assure a bank has the adequate internal controls in its mortgage banking activity? We currently have the existing banking regulators (Federal Reserve, FDIC, and OCC) which do ongoing regulatory examinations. We have the special foreclosure review of the largest 14 banks in connection with the April 2011 Consent Orders which specifically require improved internal controls and the new Consent Orders of April 2012 with the 5 largest banks which specifically require improvement of servicing internal controls. We also have the banks' auditors who give an opinion on the overall system of internal controls. Maybe having one more regulator will do the trick! Keep in mind that, under the law, it is the responsibility of each bank's management to have adequate internal controls before any outsider reviews them.**

The Bond Buyer - April 17, 2012 - Ambac Sues Bank of America Over Mortgage-Backed Securities. Ambac is seeking "redress for defendants' material misrepresentations and pervasive breaches of the parties' agreements pertaining to a mortgage-backed securitization that Merrill Lynch sponsored and marketed. Ambac stated, "To induce Ambac to issue the policy … numerous fraudulent misrepresentations [were made] with respect to (a) the characteristics of the loans pooled for the transaction, (b) the underwriting guidelines purportedly followed, and (c) the due diligence purportedly conducted to ensure the veracity of the represented characteristics". Loans for approximately 74% of the principal balance of the trust have defaulted, Ambac wrote. This suit is similar to the one filed against JPM in March.

Housing Wire – April 19, 2012 - Mortgage repurchase progress slows at Bank of America. BofA made little progress on outstanding mortgage repurchase claims during the first quarter. More than $16 billion in claims are still outstanding, and more than half come from Fannie Mae and Freddie Mac. Between the first quarter of 2011 and the end of last year, total outstanding claims grew from $11.8 billion to $12.6 billion, spiking up 26% in the first three months of 2012. Investors claim BofA violated origination standards before selling them on the secondary market, and are attempting to force the bank to buy them back. The bank formed its legacy asset division last year to settle the requests. Fannie, the largest mortgage financier in the U.S., and BofA severed business ties in February when the two disagreed over outstanding claims. "We continue to have disagreements," said BofA Chief Financial Officer Bruce Thompson in a conference call with investors Thursday. The result led to fewer claim approvals. According to the earnings statement, BofA approved $480 million in buyback requests during the first quarter, down from $1.1 billion in the previous three months and a high of $2.2 billion in the third quarter.

Bloomberg – April 26, 2012 - MetLife Sues Morgan Stanley Over Mortgage-Backed Securities. MetLife, the largest U.S. life insurer, sued Morgan Stanley for fraud over $757 million in residential mortgage-backed securities purchased in 2006 and 2007. The complaint filed states that "MetLife would only later discover, the originators whose loans collateralized the securities were among the worst of the worst culprits in the subprime lending industry" after claims that the securities were originated based on "specific underwriting guidelines" and collateralized by properties that had been "accurately appraised."

InfoBytes Blog (Buckley Sandler LLP) – April 27, 2012 - SEC Announces $28 Million RMBS Settlement. The SEC announced that it filed and simultaneously settled a suit alleging that an H&R Block subsidiary engaged in the fraudulent sale of subprime residential mortgage-backed securities (RMBS). The complaint alleges that Option One Mortgage sponsored over $4 billion of RMBS and represented to investors that it would repurchase or replace any pooled mortgage for which there was a breach of a representation or warranty. The SEC announced that Option One agreed to (i) disgorge over $14 million, (ii) pay prejudgment interest of nearly $4 million, and (iii) pay a $10 million penalty. The SEC touts this latest action as part of financial crisis-related enforcement efforts that collectively have obtained more than $1.98 billion in penalties, disgorgement, and other monetary relief. Though the investigation likely precedes the state-federal Residential Mortgage-Backed Securities Working Group and appears to have been conducted by the SEC alone, the SEC notes its role as co-chair of that group, which seeks to leverage resources to pursue alleged misconduct in the RMBS market. **RLC – See the May 3 article below from Reuters on using the Option One case as template.**

The D&O Diary (Oakbridge Insurance Services) – May 2, 2012 - Predicting Securities Suit Case Outcomes. A paper entitled "Predicting Securities Fraud Settlements and Amounts: A Hierarchical Bayesian Model of Federal Securities Class Action Lawsuits" sets out to create a "predictive model to forecast case outcomes based exclusively on information available at the time the lawsuit is filed." The authors looked at cases filed between 1996 and 2005. The variables identified that indicate that a case will most likely settle included "whether or not GAAP violations were alleged and having an individual plaintiff listed." The variables the authors found that positively impact the settlement amount included "whether or not earnings were restated". The authors speculate that an allegation of a GAAP violation significantly bolsters the merits of the case, which increases the chances the case will survive a dismissal motion. The authors suggest that this makes it more appealing for plaintiffs to take on a GAAP violation case even if the potential damage award is relatively low. **RLC—An admission of an error in accounting for repurchases would require restatements of prior financial statements and make lawsuits more attractive to the plaintiffs' bar.**

Reuters – May 3, 2012 - To silence critics, SEC should use Option One MBS case as template. How could the SEC extend the theory of the Option One case to other mortgage-backed securitizers? It's a matter of what MBS issuers knew about the originators of the loans underlying the notes they sold. Option One wasn't the only subprime mortgage originator that was in trouble in 2007 and 2008. IndyMac, New Century, Ameriquest, American Home Mortgages: the list goes on and on. They all sold loans that were packaged and resold via MBS trusts, which typically offered the same sort of put-back promises as the Option One MBS trusts, assuring investors that the loan originator was responsible for buying back materially deficient underlying mortgages. In the Option One case, there was a clear link between the originator's precarious financial condition and the MBS sponsor's knowledge of the originator's problems, since the sponsor and originator were one and the same. But couldn't the same be said about Countrywide and Washington Mutual? History certainly shows those two mortgage giants didn't have the funds to back repurchase promises. Could their successors at Bank of America and Wells Fargo be liable under the Option One theory? It would be tougher for regulators to use the Option One model against issuers that didn't originate their own underlying mortgages, but the agency could use its subpoena power to find out what exactly the banks snapping up mortgage portfolios from the likes of New Century knew about originators' true ability to make good on repurchase claims. My guess is that many of the banks were well aware of their mortgage suppliers' problems. Last month the Justice Department used the obscure 1989 Financial Institutions Reform, Recovery, and Enforcement Act to issue MBS-related subpoenas to top financial institutions. FIRREA violations, which require a lower burden of proof than criminal charges, carry stiff civil penalties for misconduct like mail and wire fraud. The SEC got almost $30 million from Option One without even explaining a damages theory.

Wall Street Journal - May 4, 2012 -UBS Loses Bid to Block Fannie, Freddie Suits. A federal judge Friday denied UBS AG's effort to dismiss a lawsuit by the federal regulator for Fannie Mae and Freddie Mac alleging the Swiss bank deceived the mortgage giants into buying billions of dollars of shaky loans during the housing boom. The FHFA filed suits against UBS and 17 other banks last summer alleging that they violated federal securities law in selling nearly $200 billion of mortgage-backed securities. The suits represent one of the most sweeping actions by a federal regulator stemming from the mortgage crisis. In the UBS case, the FHFA argued that Fannie and Freddie sustained losses of more than $1.1 billion on some $6.4 billion in mortgage-backed securities that the firms bought as investments between 2005 and 2007.

Reuters - May 8, 2012 - Damned if you do, damned if you don't: MBS trustees and put-backs. MBS trustee U.S. Bank National Association brought a put-back suit against a mortgage originator. The complaint claims that WMC Mortgage breached representations and warranties it made about a pool of loans it originated and sold to UBS for about $900 million in December 2005. UBS, in turn, securitized the loans and sold them via trusts overseen by U.S. Bank. The trustee asserts that at least 75 percent of the almost 800 randomly sampled loans it reviewed breached WMC's reps and warranties. U.S. Bank alleges that when it notified WMC of the breaches, the mortgage company refused to correct or buy back the defective loans, so the trustee sued for breach of contract. It claims to have suffered more than $70 million in damages. **RLC – This is some long awaited trustee activity. Let's see if this picks up in the upcoming months. Up to now, trustees' activity on behalf of investors has been minimal.**

Bloomberg - May 8, 2012 - Prudential Sues Morgan Stanley Over Mortgage Securities. Prudential Financial Inc., the second- largest U.S. life insurer, sued Morgan Stanley over the purchase of $1 billion in residential mortgage-backed securities. Morgan Stanley, the sixth-largest U.S. bank by assets, made untrue statements and omitted material facts before Prudential bought RMBS certificates issued with 41 mortgage-loan securitizations from July 2004 to August 2007, according to the complaint filed in state court in Newark, New Jersey. "A high percentage of the mortgage loans backing the certificates have defaulted, been foreclosed upon, or are delinquent," according to the complaint. Poor loan performance "caused a massive decline in the value of the certificates and Prudential investment losses in excess of $350 million." The bank falsely claimed mortgages met underwriting guidelines, homes securing loans were legitimately appraised, and the bank properly transferred titles, according to the complaint filed April 25.

Reuters – May 10, 2012 - Deutsche Bank to Pay $202 Million Over Mortgage Fraud. Deutsche Bank AG (DBK) agreed to pay $202.3 million to settle civil claims that its MortgageIT unit lied to qualify thousands of risky mortgages for a federal insurance program in what the U.S. called a "massive fraud." The U.S. claimed in a lawsuit filed May 3, 2011, that Frankfurt-based Deutsche Bank and MortgageIT falsely certified that they properly assessed the default risk of borrowers, qualifying loans for insurance by the Housing and Urban Development Department's Federal Housing Administration. The bank admitted to some of the conduct alleged in the complaint, according to a statement today by the office of U.S. Attorney Preet Bharara in Manhattan. The U.S. sued under the False Claims Act, which permitted it to seek triple damages and penalties of more than $1 billion. "MortgageIT and Deutsche Bank treated FHA insurance as free government money to backstop lending practices that did not follow the rules," Bharara said in the statement.

American Banker – May 11, 2011 - OCC Dismisses Foreclosure Review Consultant Amid Independence Concerns. The Office of the Comptroller of the Currency has dismissed one of the consultants [Allonhill] overseeing a massive foreclosure review after it discovered a conflict of interest in outside work the company has performed. Allonhill was the primary independent consultant for Aurora Bank FSB, and had also reviewed Wells Fargo loan files as a subcontractor for Promontory Financial Group. The OCC said it made the determination after Allonhill disclosed that it had performed work for "third parties," including reviewing loan files that are part of the same pool of loans that the company was reviewing as part of the foreclosure review. The agency said it "determined [the work] to be inconsistent with the independence requirements for independent consultants, prescribed by the OCC." "We need the GAO's independent assessment to ensure the process is fair to homeowners — especially since regulators are letting the big banks pick their own auditors," Sen. Robert Menendez, D-N.J., said in a press release at the time. "That's like letting the fox watch the henhouse." Some have also raised concerns about other consultants, including Deloitte, which is the primary consultant for JPMorgan Chase, and PricewaterhouseCoopers, which is doing reviews for Citigroup, U.S. Bank and SunTrust. **RLC—As noted in multiple comments and in the article, independence and conflicts of interest are a concern as the regulators hire consultants to execute their consent orders. This is an illustration of the complexity as it shows that a conflict does not have to be directly with the bank or banks the consultant is reviewing, but can arise from work on third party clients which impact the bank under review.**

Gibbs & Bruns LLP website – May 14, 2012 - 17 Institutional Investors Obtain Agreement From ResCap Debtors to Stipulate to $8.7 Billion Allowed Claim for RMBS Trusts in ResCap Bankruptcy. Today, seventeen institutional investors (RMBS Holders) represented by Gibbs & Bruns LLP and Ropes & Gray LLP announced they had achieved an agreement with Residential Capital LLC and its affiliated debtors (Debtors) to grant an $8.7 billion allowed claim to 392 residential mortgage backed securities trusts (the "Covered Trusts") issued by affiliates of the Debtors during the period from 2004 to 2008. The RMBS Holders hold, or manage investments for holders of, more than $13 billion in outstanding RMBS securities issued by over 350 of the Covered Trusts. **RLC – This is another rare action done through a trustee. I believe this is part of a nascent trend as trustees are beginning to be drawn into actions against loan sellers and servicers. Trustees have wanted to stay under the radar (for one thing they are mostly large banks themselves) but are beginning to be forced to act. This can have powerful ramifications which I will carefully monitor.**

Bloomberg – May 14, 2012 - First FHFA Case to Be Tried Next Year, U.S. Judge Says. The first of 16 suits by the Federal Housing Finance Agency against banks over mortgage-backed securities will be tried in New York next year, with the rest to follow in 2014, a federal judge said. U.S. District Judge Denise Cote set out a proposed schedule for the trials in a court conference with more than two dozen lawyers in Manhattan today. Under Cote's plan, UBS AG (UBSN), Switzerland's biggest bank, would be first to defend claims it misled Fannie Mae (FNMA) and Freddie Mac (FMCC) about the quality of mortgage loans underlying securities bought by the two agencies.