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ABS/MBS Litigation Outlook

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The coming months will likely bring an unprecedented amount of new litigation concerning asset-backed securities (ABS) and mortgage-backed securities (MBS) issued over the past two years. Disappointed investors are likely to pursue remedies on the strength of a variety of legal theories. Two concepts appear to be the most interesting at this point: (1) deficient disclosure about the trend of deteriorating loan quality and (2) deficient disclosure about the release of excess spread.

Trend of Deteriorating Loan Quality: Over the summer it became clear that during 2006 the quality of subprime mortgage loans that got packaged into securitizations was steadily declining. Starting in late 2005 and extending into this year, the quality of subprime mortgage loans that underpinned MBS deals deteriorated with each successive quarter.

Securitization issuers meticulously disclosed the standard characteristics of the loans that they packaged in their deals. Additionally, their disclosure materials explained that the subprime underwriting standards that they applied were less stringent than the standards specified by Fannie Mae or Freddie Mac for conforming loans. However, what the issuers may not have adequately disclosed was that their production was getting steadily worse. They were marketing riskier products and loosening their lending standards more and more as time passed.

For example, the disclosure materials generally did not highlight the fact that issuers had started to aggressively market stated-income loans to W-2 wage earners. Although the proportion of stated-income loans packaged in the deals was routinely disclosed, the changing character of the stated-income loans (*i.e.*, more wage earners) generally was not. Another example: Issuers routinely disclosed that they allowed exceptions to their subprime mortgage underwriting criteria. However, they did not generally indicate whether the prevalence of these exceptions was increasing during the relevant period. Anecdotal evidence suggests that it was.

Interestingly, a few prescient researchers focused on the issue of stated income loans to W-2 wage earners in 2005.[1] However, it was not until 2006 that the overall deterioration of loan quality became sufficiently prevalent to produce visible reactions in the market. Arguably the first visible reaction was when Standard & Poor's raised credit support levels for subprime ARMs in the third quarter of 2006.[2] In its report for that quarter, S&P noted that issuers claimed to be tightening their underwriting standards in response to rising delinquencies and early payment defaults. S&P refrained from explicitly agreeing or disagreeing with the issuers' claims. Instead, the rating agency focused painstakingly on the changes in loan attributes and let its credit enhancement levels speak for themselves.

S&P Credit Enhancement Levels for Sub-prime Mortgage Securitizations (%)

	2005Q1	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1
AAA ARMs	23.37	23.21	24.45	23.32	24.05	25.48	**28.94**	28.54	29.50
BBB ARMs	8.20	7.81	8.66	8.18	8.48	9.29	**11.42**	11.10	11.67
B ARMs	2.64	2.41	2.89	2.66	2.77	3.02	**4.32**	4.12	4.45
AAA Hybrids					24.57	24.28	**26.87**	30.09	
BBB Hybrids					8.58	8.27	**10.12**	11.83	
B Hybrids					2.87	2.81	**3.87**	4.48	
AAA Mixed	23.80	22.42	22.43	22.43	23.46	24.31	**26.30**		
BBB Mixed	8.60	7.85	7.71	7.64	7.96	8.57	**10.39**		
B Mixed	3.10	2.74	2.67	2.61	2.72	2.95	**4.12**		
AAA Fixed	21.06	18.21	19.62	21.73	19.82	22.80	21.97	22.44	21.13
BBB Fixed	8.41	6.83	7.17	8.45	7.38	9.13	8.90	8.95	8.33
B Fixed	3.79	2.90	2.88	3.71	3.07	3.77	4.03	3.92	3.47

Source: S&P RMBS trends reports

Several months later, Moody's Investors Service observed that there had not merely been a one-time shift in the quality of loans, but that there appeared to be a trend of weakening loan quality. In the first quarter of 2007, Moody's noted that "loans securitized in the first, second and third quarters of 2006 have experienced increasingly higher rates of early default than loans securitized in previous quarters."[3] A few months later, the existence of the trend was fully apparent, though its magnitude was still not entirely clear. In June, Moody's noted that "within the 2006 vintage... the performance of late-2006 pools is generally worse than that of early-2006 pools," and that "following the pattern of serious delinquencies... cumulative losses for late 2006 pools have trended higher than those for early 2006 pools at the same points of seasoning."[4]

Fluctuations in the price of the ABX sub-indices seem to confirm the timing of the market's growing awareness of the trend of declining loan quality. As shown in the chart below, the prices for the single-A, triple-B, and triple-B-minus sub-indices of the 06-2 ABX series dropped

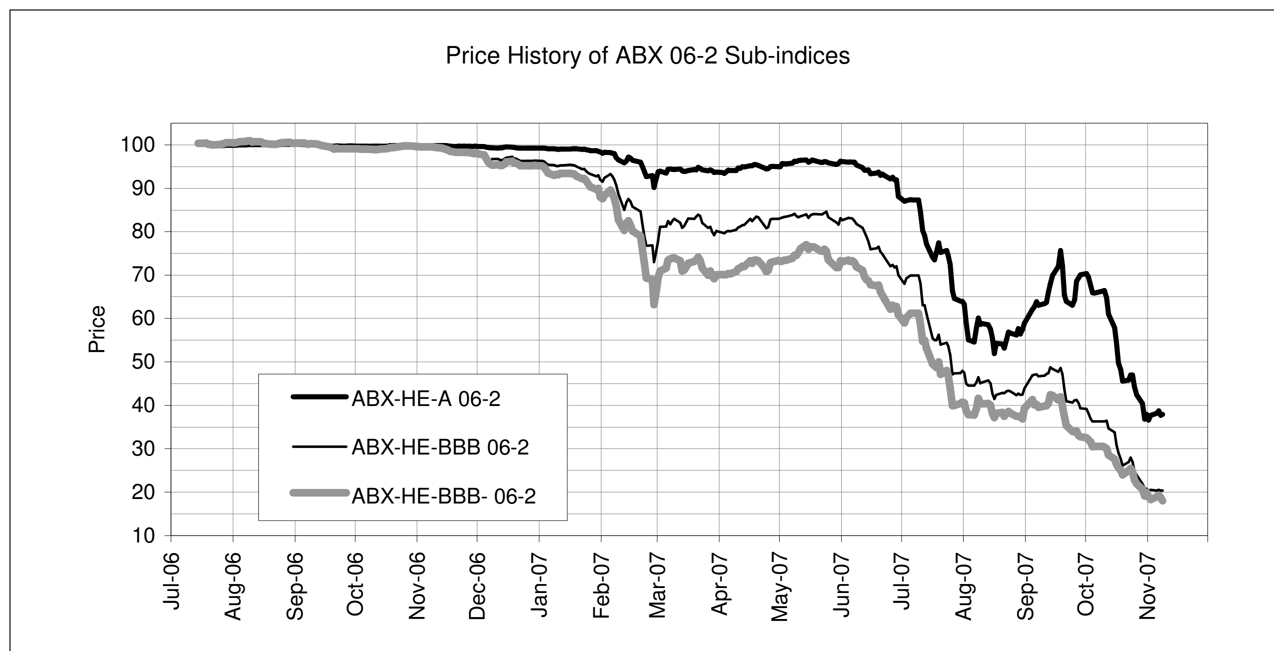
[1] *See e.g.*, Costello, G., et al., *The ABStract – 2005 ABS/CDO Market Outlook*¸ Merrill Lynch research report, p. 41 (Jan 2005); Xu, E., *Securitization Monthly*, Deutsche Bank research report, p. 18 (Aug 2005); Dubitsky, R., et al., *The Low Down on Low Doc Loans*, Credit Suisse First Boston research report, p. 2 (23 Sep 2005).

[2] Ahn, L., et al., *RMBS Trends: Results Mixed For Tightened Underwriting In U.S. Subprime Securitization Market*, Standard & Poor's special report (26 Dec 2006).

[3] Chatterjee, D., *US Subprime Mortgage Market Update: April 2007*, Moody's special report (20 Apr 2007).

[4] Fellows, E., *US Subprime Mortgage Market Update: June 2007*, Moody's special report (7 Jun 2007).

noticeably in January and February, stabilized for a few months, and then started to decline sharply again in June. By July 2007, it had become clear that the magnitude of the trend was significant, and both Moody's and S&P took widespread rating actions in the sub-prime sector.



Source: Informa Global Markets

The timing of this emergent trend is important because an investor who wants to sue based on a material omission must bring suit within a "year after the discovery of the... omission, or after such discovery should have been made by the exercise of reasonable diligence."[5] The determination of when the trend was "discovered" or "should have been" discovered will likely be a factual question in each case.

Use of Excess Spread: Prospectus disclosure about the cash flow waterfall for a typical subprime mortgage deal makes for very tedious reading. The cash flow waterfall is a somewhat complicated feature. The disclosure language is usually lengthy, repetitious, and heavily laden with cross references and defined terms. Many seasoned professionals find it tough just figuring out what it says. They find it even more difficult to figure out what it really means.

Some market participants mistakenly concluded that excess spread would not escape from a deal that had breached its delinquency trigger test. The misconception stems from the way the triggers work. In a typical deal, breaching a trigger test causes subsequent principal distributions to be in "sequential" mode. Thus, after the trigger breach, principal distributions would be applied to the tranches in descending order of seniority, so that no tranche would receive principal distributions until all higher tranches had been retired. Because excess spread is an integral part of a deal's credit support for protecting principal, some market participants thought that it was covered by the trigger feature. They were wrong.

[5] Securities Act § 17.

The surge of early period delinquencies in young subprime mortgage deals exposed this misconception. Investors viewed the high delinquencies as a signal of losses that would eventually follow. Some were surprised that excess spread continued to leave the deals even after the level of delinquencies passed the trigger levels. The trigger mechanisms did not trap the excess spread in anticipation of future losses on delinquent loans, no matter how high the level of delinquencies became. Investors were distressed to realize that the excess spread could be captured only after the delinquencies ripened into realized losses. Some holders of mezzanine and junior tranches were particularly distressed to see that residual interest, which they had viewed as the most subordinate interest in the deal, received substantial distributions of excess spread while they faced the prospect of losing their entire investment from the ultimate resolution of delinquent loans.

The issue here is not that deal structures permitted excess spread to escape after delinquencies breached the trigger levels. Rather, the issue is whether the disclosure materials were sufficiently clear on this point. It may boil down to the question of how clear and direct disclosure needs to be. Many would agree that if a prospectus states "if A then B" and "if B then C," it should not also have to state "if A then C" to complete the syllogism. However, it requires an excruciatingly long and tortuous chain of reasoning to get from the disclosure of a deal's cash flow waterfall to the practical result that excess spread can escape even after delinquencies breach the trigger level. Therefore, some disappointed investors will likely argue that the absence of a plain and clear statement that excess spread could escape from the deals, even in the face of trigger breaching delinquencies, was a material omission.

Conclusion: If disappointed investors bring cases based on the issues described above, the outcomes of those cases will likely be very sensitive to the particular facts in each one. What was the exact language of the prospectus? What was the state of actual knowledge of different parties at different times? What should they reasonably have known at different times? What could underwriters reasonably have discovered through the exercise of due diligence? One thing, however, seems almost certain: the litigators are going to have a field day.

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