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The federal housing finance agency's complaints against seventeen banks

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Abstract

Purpose – The purpose of this paper is to examine the basis of the complaints against banks which sold private label securities to Fannie Mae and Freddie Mac before the financial crisis. The examination shows that all but one of the cases was settled out of court. Nomura and RBS went to court, but the case against them was based on dubious evidence and on strict liability which only enabled the judge to set aside relevant evidence. The Securities and Exchange Commission's evidence against senior executives of Fannie and Freddie shows that they deliberately purchased PLSs based on subprime loans to meet the government's housing targets.

Design/methodology/approach – The research was based on publicly available documents, including details of the Federal Housing Finance Agency's (FHFA) complaints against the banks in question, the settlement agreements published by the DoJ, FHFA and SEC. Furthermore, it includes documentary evidence from the Financial Crisis Inquiry Committee and Senate Committees, the full transcript of the trial, opinions of the judge for the trial and the judgement.

Findings – The findings are that many have concluded that settlements out of court fail to satisfy the demand for justice. They have been criticised as a trade-off between the prosecutor and the bank, with a view that the imposition of large fines is to pay back taxpayers' money spent on rescuing the banks, rather than punishing those responsible. Such fines do little, if anything, to change the behaviour of banks. As a result, the Department of Justice issued a memorandum on 9 September to focus on individual accountability for corporate wrongdoing. It remains to be seen how many cases against senior executives will result from the change in direction.

Research limitations/implications – The implications of the research are that it is important even in the aftermath of such a serious if not devastating financial crisis to ensure that the laws are properly applied and can stand up to any challenge that it has been stretched to obtain the results the administration of the day wants to see. In addition, care must be taken over both the imposition of large fines and the use to which the monies should be put. All the parties involved in bringing about the crisis should be held to account. The major cases against the banks have almost all been "resolved". A change in direction has now taken place.

Practical implications – The practical implications of holding individuals to account should now be tackled. It requires a careful examination of the laws and regulations already in place to ensure that it is clear within a bank as to who is responsible for what. It will only be possible to hold senior individuals to account if the laws are clear and if all the evidence is not hidden. It may also require a review of the contracts under which senior executives are employed, because to remove a person from his post and then find that he still has a large pension pot and bonuses due may not result in justice either. A delicate balancing act is required because banks require highly competent and motivated individuals to run them.

Social implications – If a very large fine is imposed on a bank, the shareholders and customers pay. The shareholders will mostly own the shares through their pensions and their savings in mutual funds.

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Originality/value – There have been few studies of all the cases against the banks brought by the DoJ and FHFA and still fewer have recognized the fact that government housing policy was the source of the extent of the subprime mortgages.

Keywords Department of justice, Federal housing finance agency, Fines, Nomura, Private label securities, USA banks

Paper type Research paper

Part I. The basis of the complaints

The cases against the banks made by the Federal Housing Finance Agency (FHFA) rely on a different legal basis from those of the Department of Justice. The approach, as set out below, is much more cautious in that it relies on strict liability, but this does allow for the complaints to be made without regard to the context and, indeed, without regard to conflicting evidence. The cases brought by the SEC against chief executives and senior executives of Fannie Mae and Freddie Mac were also settled out of court, but evidence on which the SEC based its cases shows that Fannie Mae and Freddie Mac knew exactly what the contents of the private label securities were and, indeed, that was the reason for their purchase.

The complaints

These all follow a similar format, covering four areas that form the substance: the underwriting guidelines, the occupancy status of the borrower, loan-to-value and the credit ratings[1].

It is claimed that the originators of the underlying mortgage loans systematically disregarded their underwriting guidelines. The collapse of the (MBS) certificates is also taken to indicate that the mortgage loans were not originated in accordance with the guidelines. This was further confirmed by the surge in mortgage delinquency and default in 2008.

The full details of the data review and the evidence gathered to support the FHFA's complaint are not provided in the complaints. This is despite the fact that the FHFA has subpoena powers, i.e. they have access to the underlying loan files without having file a lawsuit and proceed through discovery. Because only the Nomura case went to trial, it is not possible to gauge the strength of the evidence. However, in the case of Bank of America, for example, the FHFA stated that an:

> […] industry standard automated valuation model was used to calculate the value of the underlying property at the time the mortgage was originated. AVMs are routinely used in the industry as a way of valuing properties […] AVMs rely on similar data as appraisers-primarily county assessor records, tax rolls, and data on comparable properties. AVMs produce independent, statistically-derived valuation estimates by applying modelling techniques to this data.

The FHFA makes the same claim about the use of the automated valuation model (AVM) in each case, an interesting claim, given the revelations about the use of the specially prepared AVM in the Nomura trial[2]. This will be further explored in section 3.

The credit rating agencies

The rating agencies are criticised for their role in the financial crisis. The complaints, whilst relying on the evidence gathered during the Financial Crisis Inquiry Commission (FCIC) for the issue of inflated appraisals, sets aside the extensive evidence of the FCIC

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regarding the activities of the rating agencies at that time. The behaviour of the rating agencies, on which the regulators expected investors and companies to rely, left much to be desired. The problems of inaccurate ratings were not only the result of conflicts of interest, in that, the companies which they rated and whose products they rated also paid fees to the rating agencies for doing so. In a memorandum to the members of the Permanent Subcommittee on investigations, Senators Carl Lewis and Tom Coburn set out the main problems with the rating agencies, resulting from an inquiry into their activities based on over 100 interviews and depositions, millions of documents and consultations with a wide range of experts. Their conclusions were that between 2004 and 2007, the agencies had relied on inaccurate rating models, given in to competitive pressures to obtain market share and failed to re-evaluate existing RMBSs or CDO models, even though by 2006 they knew that their models were inaccurate and required revision.

They then delayed thousands of rating downgrades, allowing these securities to carry inflated ratings that could mislead investors. Between 2004 and 2007, Moody's and Standard & Poor (S&P) knew about the increased credit risks due to mortgage fraud, lax underwriting standards and unsustainable housing price appreciation, but failed to incorporate these adequately into their credit rating models. Not only that, but despite record profits from 2004 to 2007, they failed to assign sufficient resources to rate new profits adequately and test the adequacy of existing ratings:

> A flavour of what that meant is given in the words of Moody's Chief Credit Officer in his evidence to the Subcommittee, "What happened in "04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts, Everything was investment grade[3].

What this indicates is that it was hardly the type of errors set out in the court hearings, which "misled" the rating agencies. They were aware of the extent of subprime lending long before "rating" the MBSs listed and were complicit in providing investment grades as a matter of course to RMBSs and CDOs issued by a wide range of lenders.

The department of justice brings cases against the rating agencies. The Department of Justice brought cases against the rating agencies, beginning with S&P's for fraud in rating the mortgage-backed securities in the years leading up to the financial crisis[4]. The law suit alleged that "S&P engaged in a scheme to defraud investors in structured financial products known as RMBSs and CDOs", which led to losses of billions of dollars on CDOs, for which S&P issued inflated ratings that misrepresented the securities' true credit risks. The complaint also alleges that S&P falsely represented that its ratings were objective, independent and uninfluenced by S&P's relationships with investment banks when, in actuality, S&P's desire for increased revenue and market share led it to favour the interests of those banks over investors'. This complaint, like many others was filed as a result of the President's Financial Fraud Enforcement Task Force, established to "wage an aggressive, co-ordinated and proactive effort to investigate and prosecute financial crimes".

The particular complaint against S&P was finally settled in February 2015, when S&P agreed to pay $1.37 billion to settle claims that it relaxed standards to win business in the run-up to the financial crisis during 2004-2007[5]. *The Economist's* comments on the case raises some interesting points. In "A Fine too Far", it poses the question as to whether it was a deliberate attempt to deceive or an error of judgement? "Had the case

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gone to court, S&P was prepared to argue that its ratings were echoed by its rivals, as well as central bankers who had no incentive to mislead". The article adds that the Department of Justice was "unwilling to put forward its own case raises even more suspicions, particularly because it was willing to settle for hard cash without any acknowledgement of S&P's responsibility"[6].

The Department of Justice had expected to wait until the case against S&P was tested in court before proceeding against Moody's. That did not happen, but the settlement apparently was enough for the department to consider bringing a case against Moody's on the same grounds, namely that Moody's fraudulently inflated ratings of risky mortgage securities. In February 2015, the Department of Justice officials confirmed to *The Financial Times* that they had begun meeting former Moody's executives to discuss ratings that the company had issued on RMBSs between 2004 and 2007. Moody's allegedly miscalculated the risk of subprime mortgages resulting in triple A ratings that made MBSs more attractive to investors. The issue of the fraud seemed to be part of the complaint. To date (September 2015), no complaint has been brought against Moody's, although media reports in February and March suggested that the DoJ was in the early stages of investigations.

All the FHFA cases refer to the banks and the credit rating agencies. The complaint against the Bank of America and others, including Merrill Lynch, Pierce and Fenner & Smith, explains the relevance of the credit rating agencies. In section 109, the FHFA points out that:

> […] each tranche of the Securitisations received a credit rating upon issuance, which purported to describe the riskiness of that tranche […] The credit rating provided for each of the GSE Certificates was "investment grade", almost always "AAA" or its equivalent […]. The ratings for the securitisations were inflated as a result of the defendants provision of incorrect data concerning the attributes of the underlying mortgage collateral to the rating agencies, and, as a result, defendants sold and marketed the GSE certificates as AAA (or its equivalent) when, in fact, they were not[7].

Reference is made to the various examinations of the role of the credit rating agencies because this suggests that the FHFA's complaints may have rested on insecure foundations in these cases. Furthermore, it is a failure of the role of a credit rating agency because it accepts the information provided by the company concerned without questioning and testing that information.

Part II. The FHFA's complaint against Nomura and RBS

The complaint against Nomura

Nomura Holdings is the only bank out of the 18 banks which refused to settle out of court. The original complaint was lodged on 2 September 2011. The complaint follows exactly the same formula as the complaints against all the other banks. The interest in this case is that the evidence for the allegations is set out in detail. The factual allegations arise out of the offer and sale of residential mortgage-backed securities to Fannie and Freddie. The securities were sold on the basis of registration statements, including prospectuses and prospectus supplements, which contained materially false or misleading statements and omissions. It was alleged that defendants falsely represented that the underlying mortgage loans complied with certain underwriting guidelines and standards, including representations that significantly overstated the ability of the borrowers to repay their mortgage loans. Between 30 November 2005 and

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30 April 2007, Fannie Mae and Freddie Mac purchased over $2 billion in RMBSs issued in connection with seven Nomura-sponsored securitisations. All the relevant documents were filed with the SEC, the details of which were subsequently examined during the court proceedings.

Fannie Mae and Freddie Mac purchased over $2 billion of the certificates for the RMBSs on the basis of the registration documents filed with the SEC. These:

> […] contained misstatements and omissions of material facts concerning the quality of the underlying mortgage loans, and the practices used to originate and underwrite such loans. As a result of the defendants misstatements and omissions of material fact, Fannie Mae and Freddie Mac have suffered substantial losses, as the value of their holdings has significantly deteriorated.

Fannie Mae and Freddie Mac in the run-up to conservatorship in September 2008

In the spring of 2008, Fannie and Freddie were heavily invested in private label securities. Delinquencies and defaults were increasing on the subprime mortgages with which they backed the securities they guaranteed; therefore, investor confidence in the GSEs continued to fall. They had $5.87 trillion in assets and $83.3 billion in core equity at the end of 2007. Fannie's leverage ratio was 76 to 1 with $45.4 billion in core capital and $3.3 trillion in loans, securities and guarantees. Freddie had a leverage ratio of 64:1 with $37.9 billion in core capital and $2.41 trillion in assets.

James Lockhart replaced Armando Falcon as the new OFHEO Director in May 2006, whilst recognising that he neither had insufficient powers for the job, in particular, the power to set capital standards, nor the funds (which were the subject of annual review from the federal budget). The capital standards were set by statute, and were only 2.5 per cent against whole loan mortgage assets, with a low risk weighting for MBSs. These guarantees only required 45 basis points or 0.45 per cent of capital. Lockhart eventually got the Freddie Mac board to agree to cap the growth of its $722 billion portfolio to 2 per cent a year until the firm was able to file its quarterly earnings to the SEC on time. In May 2006, Lockhart recalled that the Freddie Mae board said that they understood credit risk, but did not have any.

An examination of the records showed that even as far back as December 2003, the GSEs were struggling to meet the housing goals. Freddie Mac paid $100 million in non-refundable fees to Washington Mutual to:

> […] induce the company to swap approximately $6bn of multi-family loans for 100 per cent of the beneficial interest in those loans in the form of mortgage –backed securities issued by Freddie Mac. Since the Company has the unilateral right to collapse the securities after one year, the Company has effectively retained control over the loans […]. This transaction was undertaken by Freddie Mac in order to facilitate fulfilling its 2003 affordable housing goals as set by the Department of Housing and Urban Development[8].

A Freddie Mac memo referred to PLSs as necessary for achieving the housing goals. "These assets are extremely goal-rich and a key element in meeting our housing goals, especially subgoals"[9] In 2005, in response to a query from Fannie Mae, "HUD provided a detailed memorandum describing how the GSEs could receive affordable-housing goal credit if they purchased only a portion of a PMBS issuance[10]" As late as 2007, Daniel Mudd, in a letter to Brian Montgomery, then the Assistant Secretary of Housing:

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> One strategy that Fannie Mae has used in the past to meet the subgoals is the purchase of private label securities (PLSS or PMBSs). In 2006, purchases of PLS contributed significantly to subgoals performance, increasing our scores by nearly 2 percentage points on the low-to-moderate-income subgoal and 80 basis points on our special affordable subgoal. However, Fannie Mae's ability to source and purchase PLS that meet the goals has fallen off because the issuance of PLS has fallen significantly. Issuances of PLS declined markedly in the third quarter, particularly in the areas of subprime and Alt-A mortgages[11].

Not only did Fannie (and Freddie) purchase PLSs based on subprime and Alt-A loans but they clearly sought them out. That is quite different from the picture painted during the trial.

In his statement before the Senate Committee on Banking, Housing and Urban Affairs on 23 September 2008, as Fannie Mae and Freddie Mac were taken into conservatorship, James Lockhart pointed out that:

> […] the GSEs had $5.3 tr of guaranteed mortgage-backed securities and debt outstanding, which is equal to the publicly held debt of the USA. Their market share of all new mortgages was 76 per cent during the first half of this year […] In retrospect and despite OFHEO's surplus capital requirements, portfolio caps, and repeated warnings about credit risk, the credit profile of both Enterprises followed the market down in 2006 and 2007-without commensurate pricing for risk. They bought many more low documentation, low verification and non-standard ARM mortgages than they had in the past […] For Fannie Mae, roughly 40 per cent of new business in the first half of 2007 was in the Alt-A and interest only products versus 26 per cent in 2005. The quality of the holdings of PLSs issued by others also deteriorated[12].

This was despite the fact that the Director of OFHEO had done everything within his (limited) powers to ensure that Fannie and Freddie reorganised their chaotic structures, filed the accounts with the SEC, which they had previously failed to file following the discovery of the "accounting irregularities" in 2003 and 2004, reduced their portfolios and increased their risk capital.

In the summer of 2008, OFHEO saw that the book of business at Fannie and Freddie "was starting to deteriorate badly". Perhaps it was then that OFHEO began to examine the PLSs bought by the GSEs in the hope of a "pushback" as a means of raising funds for them or perhaps it came about as a result of the "full-scale activity" in August with both the Fed and the Office of the Comptroller of the Currency to "figure out how big the (capital) hole was in each case". The treasury was also involved. All came to the same conclusion. "It was obvious that there was no capital left. Or they would have no capital left in three to six months[13]". The fact that the complaint focussed on strict liability only meant that the entire context in which Fannie and Freddie operated together with the manner of their conduct of business could be set aside.

The complaint

The complaint focuses on a limited number of private label securities purchased by Fannie and Freddie during 2005-2007 from Nomura during a time in which the company rapidly expanded the volume of the securities it issued compared with previous years: from $687 million in 2003 to $2.4 billion in 2004, $7.2 billion in 2005 and $10 billion in 2006. This was not surprising given the financial incentives to do so, and one might add, the financial incentives for Fannie and Freddie to buy them.

The complaint refers as part of the general background to the alleged negligence and misrepresentation to the President's Working Group on Financial Markets, March 2008.

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The report, entitled "Policy Statement on Financial Market Developments" found that there was a significant erosion of discipline by those involved in the securitisation process and the turmoil in the financial markets clearly was triggered by a dramatic weakening of underwriting standards for the US subprime mortgages. The latter point verges on nonsense given the history of affordable housing and its impact on mortgage lending. The interagency statement on subprime mortgage lending was not made until 29 June 2007. The regulators expected companies to rely on the credit rating agencies for the assessment of MBSs and PLSs. The only problem with the recommendations of the President's Working Group is that they did not apply to the whole mortgage industry from 1995 onwards. If that had been the case, then the financial crisis may not have occurred.

The complaint sets out the range of errors and misrepresentations found in the registration statements and the prospectus supplements, which, it is claimed, meant that the GSEs were misled so that they bought PLSs, which contained what were later called "toxic" assets. As a result of these errors and misrepresentations they lost billions of dollars.

The complaint sets out these as follows:

- Lack of compliance with underwriting standards intended to assess the creditworthiness of the borrower, the ability to repay the loan and the adequacy of the mortgaged property as security for the loan.
- The occupancy status of the borrower (for his primary residence, second home or an investment property). This is taken to be an important factor in determining the credit risk associated with the mortgage loan.
- Statements regarding the loan-to-value ratios, which in turn depend on the accuracy of the appraisal. This is also an important indicator of default risk.
- Statements regarding the credit ratings, including Moody's, S&P's and Fitch's ratings. The credit rating provided for each GSE certificate was always "investment grade". This was because the defendants, it was claimed, provided the rating agencies with incorrect data.

All of these claims made by the FHFA are based on the strict liability of the defendants Nomura Securities and RBS Securities for making false and misleading statements in the registration statements applicable to one or more securitisations and for omitting facts necessary to make the facts stated not misleading. The strict liability applies to the prospectus supplements as well. The suit was brought under the Securities Act, which imposes absolute liability for material misrepresentations by an underwriter and both Nomura and RBS were underwriters. In that case, once material misrepresentations by the underwriter are shown, what was in the plaintiff's mind as the buyer is irrelevant. Therefore, the reasons why the GSEs bought the securities, including the housing goals, are considered to be irrelevant by the court. Hence, the issues revolve around the mistakes Nomura and RBS made, if indeed, they were mistakes. The usual statutory defence for an underwriter is due diligence. The underwriter is due diligence, that the underwriter diligently tried to ascertain the facts, but just made mistakes. In this case, the defence sought to show that the alleged mistakes were not in fact mistakes or have not been shown to be such.

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It is also claimed that:

> Fannie Mae and Freddie Mac purchased or otherwise acquired the GSE certificates pursuant to the false and misleading registration statements. Fannie Mae and Freddie Mac made these purchases in the primary market. At the time they purchased the GSE certificates, Fannie Mae and Freddie Mac did not know the facts concerning the false and misleading statements and omissions alleged herein, and if the GSEs had known those facts, they would not have purchased the GSE certificates.

However, by the time the trial began in March 2015, the FHFA was allowed to limit its strict liability claims under Section 12 (a) (2) of the Securities Act as well as the Blue Sky laws to just four issues: the falsity of the alleged misrepresentations, the materiality of the alleged misrepresentations, the loss causation defence as to the Section 12 claim only and damages.

Part III. The Nomura trial

Evidence rejected

Then followed the rejection of much of the evidence which the defence offered. A list of the Opinions and Motions is provided in an Appendix, but a brief description of some of the evidence excluded is provided here. The first is Document 997, which describes the automated underwriting systems developed by GSEs, described in the Opinion and Motion as:

> […] rules-based underwriting program in which originators input loan characteristics and then received a report and recommendation concerning credit risk and recommendation concerning credit risk and eligibility for purchase by the GSE.

This evidence concerning the details of ways in which the systems operated is excluded as evidence. The evidence proposed by the FHFA's witness on "minimum industry standards" will be considered in an analysis of the court proceedings.

The judge allowed the defendants to reject some of the evidence given by John Kilpatrick, which will be discussed in greater detail in the next section. The purpose of his evidence for the FHFA is to testify regarding the "falsity of the loan-to-value ratios recited in the defendants" offering documents. The defendants' lawyers were able to remove Kilpatrick's opinions regarding the credibility of the appraisers and the FHFA's attempt to establish that at least some of the appraisers did not actually believe that the appraisals they admitted at the time that the appraisers accurately reflected the property values. Kilpatrick was allowed to submit his evidence regarding the credibility of the appraisals.

In this case, the judge allowed the 232 documents relating to the GSE's post-purchase surveillance of their respective certificates' performance and the documents relating to the GSEs PLS accounting impairments. The judge did not allow the defendants to submit the Fannie Mae Subprime Weekly e-mails, some 153 documents. These e-mails do show that Fannie Mae's traders were aware of the nature of the PLSs they were buying[14].

Defendants' Pretrial memorandum of law

The arguments presented by the defendants seek to demonstrate that the FHFA had not substantiated its claim that there were no false or misleading statements in the offering documents. The key issues in the FHFA's case are that false claims were made about the

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loan-to-value ratios, owner occupancy status and the credit rating of the certificates. Based on an evaluation of only 5 per cent of the loans supporting the loan groups for the seven certificates in question, it is alleged that 68 per cent of the loans were not underwritten by the underwriting guidelines; the percentage of the "owner-occupied" loans was overstated by 7.19 per cent and the appraisal values were inflated by 11.1 per cent.

The evidence for these claims on the part of the FHFA comes from two experts: John Kilpatrick, using a retrospective AVM to examine the appraisals on which the LTVs were based and Robert Hunter on the underwriting standards applied to the originations. The defendants further argued that the alleged were not the causes of any losses suffered by Fannie Mae or Freddie Mac, because the fact was that house prices declined by about 33 per cent between April 2007 and May 2009[15]. However, the defendants' expert, Kerry D Vandell's evidence on this point and that the errors, even if they existed, would not have had an impact on the losses, but his evidence was ruled out.

John Kirkpatrick and the retrospective AVM

The FHFA commissioned Kilpatrick to develop an AVM which was designed specifically for the purpose of this litigation for which he was paid $1.5 million. The purpose of the model was to show that the appraisal values on which the LTV and CLTV ratios were based were objectively false. He then applied another model, which he had also developed, the credibility assessment model for the purpose of this litigation to show that the appraisals were not "credible" under the Uniform Standards of Professional Appraisals Practice (USPAP). This model is a set of 31 questions devised by Kilpatrick and assigned various weights by him. The model has not been peer reviewed and is not used by anyone else in the industry. It has not been independently tested or validated, even though federal standards require such a testing.

This is against the background in which the warnings are clearly in the prospectus supplements. The data concerning "loan-to-value" is "not static" because the value in that ratio "may be less than the 'value' at origination and will fluctuate from time to time based on changes in economic conditions and the real estate market". It does seem odd to suggest that the value of residential property remains constant and the warning about a possible fall in value would be a standard regulatory warning. The problem in the period from 2000 onwards was that too many observers easily made the assumption that house prices would continue to rise, although there were signs for those who chose to look that continuing rise in prices had begun to falter for some observers in 2006 and for most in the second quarter of 2007. The defendants noted that Freddie Mac was well aware of that. Patti Cook, Freddie Mac's Vice President of Investments and Capital Markets, who was in charge of its PLS trading, stated in her January to March 2007 column in Freddie Mac's "Strategic Perspectives" that rising house prices in the past few years have protected a large number of borrowers from defaulting because they could refinance or sell their home. That is no longer true – slowing house price appreciation and climbing rates have left a large number of borrowers exposed.

The Plaintiff's only evidence for the inflated appraisals is Kilpatrick's testimony was based on his Greenfield AVM. On this basis, Kilpatrick argues that the original appraisal values of 2008 of the 672 properties were inflated by over 15.1 per cent, making the appraised value "significantly higher" than the "true" value of the property and hence "inaccurate". He claims that the appraisals of Nomura's sample properties were

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inflated by 8.2 per cent. Perhaps the most telling fact is that the retrospective AVM did not rely primarily on only tax-assessed values from 2010 to 2014! These values are not accepted in the appraisal industry as an indicator of market values. The current tax-assessed values reflect the changes in the real estate market since the years 2005-2007. House prices dropped by 30 per cent on average throughout the USA.

Robert Hunter and re-underwriting a sample of 723 loans

First of all, the accuracy of the offering documents must be assessed in the light of the information available when they were published. For two of the securities, all the loans were originated with Fremont, and for the remaining five, the loans were originated with various investment banks, savings and loans organisations, mortgage bankers and others, and the underwriting standards were clearly described as "originated generally in accordance with the underwriting standards described in this section". This indicated clearly that, for example, information about the borrower was "generally given, except that the income or assets may not be, " and "certain exceptions to the underwriting standards described in this prospectus supplement were made". These "Modified Standards" allow "different underwriting criteria" and the loans "have originated under educed documentation, no-documentation or no-ratio programs[16]". This general description of the relevant underwriting criteria is all that was required by Regulation AB for the "criteria used to originate or purchase the pool assets". Hence, the defendants conclude that there is "no evidence to show that between 22 per cent and 100 per cent of the loans" described above "deviated from the disclosures in the offering documents[17]".

In response to Hunter's claims that 66.7 per cent of the claims in his sample were "materially defective, the defendants point out that when Nomura conducted its due diligence process, which examined 39 per cent of the loans in the supporting loan group for underwriting compliance, they found that only 6.6 per cent of loans were potentially materially defective[18]. What is more important is that Freddie Mac also reviewed these loans and agreed. Freddie Mac's reviews of originators of the loans underlying the certificates approved of the originators" processes and found low defect rates. Other issues such as those regarding missing items from loan files years later were rejected by the defendants because it was often the case that the originator was able to locate the missing document, as evidenced by Clayton, Freddie Mac's head of counterparty reviews and others, provided they asked.

However, apart from these details, what is most interesting about Hunter's evidence was his introduction of Minimum Industry Standards. These were developed by Hunter and two other experts provided by the FHFA, whilst they were re-underwriting loans for this complaint and other similar actions in 2013. However, Minimum Industry Standards simply did not exist from 2005 to 2007. They were not provided by the regulators or any other industry group. Indeed, the first time that an interagency agreement, which fully recognised the dangers of subprime lending, came into existence was on 29 June 2007 (Interagency Expanded Guidance for Subprime Lending).

Cross-examination during the trial

John Kilpatrick. Under cross-examination, certain issues arose concerning the development of the Greenfield Advisors (his company) AVM, which was designed specifically for FHFA's case against Nomura. The AVM was almost always used

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instead of a physical inspection of the property and Kilpatrick had carried out very few such inspections. Indeed, neither he nor his staff physically inspected any of the selected 672 sample properties that were valued by the AVM. The model itself had never been reviewed in any academic or industry publication. It is only licensed for the purpose of litigation, and the version used for the trial was not licensed for use outside the FHFA litigation. Exactly the same points applied to the "credibility assessment model", which he had developed for the purpose of the FHFA's case (and related cases). Other widely accepted methods of appraisal reviews are available which had been peer reviewed. It also emerged that he was "deposed a few times", but he "ended up testifying in one of them[19]". However, it should also be noted that, although there are four other retrospective AVMs, none of them were used for the purpose of computing appraisal inflation seven or more years ago. They are not capable of that[20].

Kilpatrick explained that he relied on the tax-assessed values. It emerged from the cross examination that for him the tax-assessed value is used as a proxy for every aspect visible or invisible of a property that has some impact on its value[21]. (The example was given of Massachusetts, with the fact that properties are assessed only once every 10 years, and it is illegal for tax assessors to enter the property). It is not just the infrequency of inspections that are a problem but that the public records are inadequate and inaccurate, for example, regarding the number of bedrooms, bathrooms, square footage, etc.

That was not the only problem with the model. Kilpatrick apparently used filters in an interesting way. In answer to the defendants' questions, he explained that he did not carry out an analysis to ascertain the correlation between the contemporaneous market value and tax-assessed value in every jurisdiction in which Nomura's loans were situated, but for every particular loan, "after filtering out all of the tax-assessed data that did not work with his model". "The filter was one way of testing which data would not comport with my model[22]".

Counsel for the Defence pointed out that as early as 2005, Fannie and Freddie permitted mortgage originators to rely solely on the results of AVMs to determine the value of mortgaged properties. This has changed since the publication of the Interagency Appraisal and Evaluation Guidelines in 2010, which do not allow the use of an AVM for an appraisal of the property without a physical inspection. The AVM does not constitute an appraisal. The guidelines also make it clear that 'an institution may not rely solely on the data provided by local tax authorities to develop an evaluation (unless the resulting evaluation is consistent with safe and sound lending practices). In addition, certain conditions apply to the use of tax assessment valuations (TAV) including:

A valid correlation between the tax assessment data and the market value.

Determine and document how the tax jurisdiction calculates the TAV and how frequently revaluations occur.

Carry out an analysis to determine the relationship between the TAV and the property market values within a tax jurisdiction.

Test and document how closely TAVs correlate to market value based on contemporaneous sales at the time of the assessment and revalidate whether the correlation remains stable as of the effective date of the valuation.

However, it is on the appraisal that the decision about the loan-to-value rests, yet, although Kilpatrick uses his model in this way, there is "no industry practice about retrospectively recomputing LTVs[23]". It appears that since the model was

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constructed for the purpose, and that its basis is not acceptable, the conclusions to which it leads might well be unacceptable as well. To use tax assessments carried out in 2010-2014, with all their inadequacies, and to argue that appraisals carried out in 2005-2007 were inflated does seem to stretch credibility more than his credibility assessment model itself does. The latter apparently bears little resemblance to an appraisal review as defined by USPAP, but if an appraisal fails any one of very strictly and tightly defined criteria (e.g. about how many feet away from certain conditions a house has to be before it should be labelled as having external obsolescence, rules of his own invention)[24].

The cross-examination of Robert Hunter. In the cross-examination, it emerged that Robert Hunter's experience as an underwriter went back to 1983, when underwriting standards were much stricter and before the introduction of computerised loan integration systems. He was subsequently in charge of managing the credit quality group at Countrywide Bank using both an automated underwriting system and an automated processing system between 2001 and 2005. Prior to acting as a forensic underwriter for the FHFA case, he had never carried out a forensic review.

The point made by the defendants was that the loans to which Mr Hunter refers "were originated generally in accordance with the underwriting criteria described in this section". During the cross-examination of Hunter's evidence, the implications of applying his "industry minimum standards", which did not exist at the time, became clear. His guidelines were even more stringent than those used by Fannie and Freddie at that time. These were not the standards described in the documentation provided to investors by Nomura. The documents set out the standards that were generally applied, making it clear that there were many exceptions to the guidelines set out by the issuers. For example, EquiFirst, as one of the loan providers, states clearly that "most loans will not fit every guideline [25]". Various compensating factors are listed, including that the "applicant has pride of ownership." The defence referred to Fremont's guidelines as well, which took a "holistic approach" to underwriting. The guidelines stated that:

> […] every loan application package represents a big picture. Each characteristic of this picture is carefully evaluated to establish a sound underwriting decision […]. This philosophy is incorporated throughout the guidelines. And Fremont encourages its brokers to submit loans that make sense[26].

The point here is not whether or not the underwriting were appropriate, but is it clear that Fremont, EquiFirst and many other banks applied the type of "flexible" underwriting criteria current at that time. Imposing much stricter criteria, presented as "minimum industry standards" supports the claim that there were many misrepresentations or misleading statements in the prospectus and supplementary documents, which would not have been regarded as such at the time for a variety of reasons. Stated income loans were widely accepted and offered.

The re-underwriting involved checking the reasonableness of the borrower's stated income by looking at the Bureau of Labour's statistics provided the borrower was employed. This is despite the fact that the Secretary of Labour stated that the BLS statistics should not be used for this purpose. Furthermore, underwriters did not use these statistics to check the borrower's stated income at that time. The guidelines called for a verbal confirmation from the borrower of his or her

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employment and a written verification of employment from the borrower's employer certifying the borrower's date, place and status of employment. By imposing rules which did not exist at the time, (whether or not one considers that they should have been applied, but the fact remains that they were not), Hunter makes it appear that there are numerous misleading statements regarding borrower income and ability to repay. Alt-A, or no-doc, low doc-loans were a widely recognised type of mortgage available then.

Hunter also claims that there are errors in the issue of owner occupancy for loans for house purchase. Prior to closing the purchase, the lender only has the borrower's statement of intent. The loan application that the borrower makes at the time of origination is sworn under the penalty of perjury and later so is the bankruptcy petition. The bankruptcy petition could be filed some years later than the original purchase of the property. If the addresses differed, then the loan to the borrower was considered to be a defective loan. It seems that many of the "defective" loans were classified as such, even though several years may have passed between the purchase of the property and the bankruptcy proceedings. Credit applications are also taken into account if they differ from the originator's loan address for the borrower. These are taken to show that the loan is defective without full investigations of ownership of two homes, using the address of relatives, mistakes made in audit credit reports or the fact that the borrower may not be able to live in the property for a variety of reasons, e.g. death of a partner or job losses. The borrower may have to move out of the house, let it out and live with relatives or friends until it can be sold. As the recession deepened from late 2007 onwards, this must have been a frequent occurrence. Yet, Hunter used both audit credit reports, which would not have been available at closing, and bankruptcy petitions, which were often filed in 2009 and 2010. Such information would not have been available to the underwriter or the originator at the time of closing. Hunter includes in his minimum industry standards that there was an obligation on the underwriter to investigate potential misrepresentations of occupancy, but this was not the case at that time[27].

Part IV. The SEC's complaints against Fannie Mae and Freddie Mac

Throughout the trial, little reference was made to the actions of Fannie Mae and Freddie Mac. This was in part due to the fact that relevant depositions such as that of the Director of OFHEO, James Lockhart III, who knew every aspect of Fannie and Freddie and worked hard without the necessary powers, to persuade Fannie and Freddie to reduce their portfolios and increase their capital, were rejected. Even as late as August 2007, Fannie and Freddie thought "they could save the mortgage market" according to Lockhart. A witness who could provide detailed and intimate knowledge of Fannie and Freddie was not required to give evidence. Justice Cote struck it out.

In December 2011, the Securities and Exchange Commission brought its complaints against the senior management of Fannie Mae and Freddie Mac. The SEC alleged that Fannie Mae and Freddie Mac misled investors into believing that their exposure due to subprime loans was less than it was through their false and misleading statements between 23 March 2007 and 6 August 2008. The cases did not go to court at all, but the defendants agreed to accept responsibility on the basis of non-prosecution agreements, without admitting wrong doing, co-operated with the regulator and did not admit at doing any wrong. The cases primarily related to subprime loans and their single family

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loans and their failure to report the extent of their subprime exposure. However, the complaints also reveal that Fannie and Freddie certainly did purchase private label securities.

The SEC quotes from Fannie Mae's 2006 Form 10-K:

> We have also invested in highly rated private label mortgage-related securities that are backed by […] subprime mortgage loans. we estimate that […] private label mortgage-related securities backed by subprime mortgage loans, including resecuritizations, accounted for approximately. 2 per cent […] of our single-family mortgage credit book of business as of 30 June 2007.

Again, on 9 May 2007, Form 12v-25 filing, the SEC points out that for the first time, Fannie Mae disclosed a quantification of its Alt-A holdings, defining Alt-A as loans with "lower or alternative documentation".

> As described below in the discussion of our Capital Markets group, we also have invested in highly-rated private-label mortgage securities backed by Alt-A loans. We estimate that approximately 1 per cent of our total single family mortgage credit book of business consisted of private-label mortgage related securities backed by Alt-A mortgage loans as of both March 31, 2007 and December 31, 2006.

In March 2007, "we held in our investment portfolio approximately $43.5 billion in private-label securities backed by Alt-A mortgage loans", in 9 November 2007, in its 2007 Forms 10-Q for the first quarter. The reason for including all these excerpts from the SEC's complaints against Fannie Mae's senior management is that they make it clear that Fannie understood what type of loans backed PLSs.

Freddie Mac clearly purchased PLSs for the same reason. On 18 July 2008, Freddie Mac voluntarily registered its common and preferred stock under Section 12 (g) of the Exchange Act, but before that date, Freddie Mac publicly disseminated annual and quarterly reports of its financial condition and results of its operations in information statements and supplements to those statements. In 2006, in its information statement and annual report, Freddie Mac noted "that it participated in the subprime segment in two other ways: our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment"[28]. The 2006 Information Statement also disclosed that on 31 December 2006 and 2005, in its retained portfolio, Freddie Mac held "approximately $124 billion and $139 billion, respectively, of non-agency mortgage-related securities backed by subprime loans". The 2007 Information Statement Supplement also disclosed that, on 30 June 30 2007 and 31 December 2006, Freddie Mac held in its retained portfolio, "approximately $119 billion and $124 billion, respectively, of non-agency mortgage-related securities backed by subprime loans[29]". On 11 December 2007, Syron stated at a Goldman Sachs & Co., Financial Services Conference in New York, "I mean, we bought some securities, which we can go through, and we think we are fine in. We bought them for goal purposes[30]". In the 2008 Form 10-Q, as of 30 June 30 2008 and 31 December 2007, the value of the non-agency securities backed by subprime loans was given as approximately $86 billion and $101 billion, respectively. From the SEC's complaints, it is clear that both Fannie and Freddie held billions of dollars in PLSs backed by subprime loans and they were held for the purpose of meeting the goals. In other words, not only did Fannie Mae and Freddie Mac know what they were buying, but they deliberately bought such PLSs.

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Such evidence was rejected by Judge Cote, but this is because the fact that meeting the goals involved (inevitably) subprime loans, as explained in the Introduction. The fact that such loans reached about half of all the loans outstanding in 2008 and that such loans had began to default at an alarming rate from mid-2007 onwards was the principal cause of the crisis, and 74 per cent of these were on the books of Fannie Mae and Freddie Mac or other government-controlled or regulated agencies. This shows where the demands for these loans originated. The failure of these loans drove down housing prices, weakening the financial institutions holding them. This led to the panic and crisis. It was inevitable that the loans were subprime and underwriting criteria had to become more "flexible", otherwise those whose incomes were at or below the median income in the areas in which they lived would not have been able to buy their homes. Clinton's American Dream would not have been fulfilled. Refusing to admit, not only the SEC evidence but also that of James Lockhart, Director of OFHEO, the then regulator of Fannie Mae and Freddie Mac meant that evidence of the weakness and mendacity of the GSEs' management, their lack of capital and OFHEO's lack of supervisory and regulatory powers was not revealed.

Part V. Judge Cote's decision

This was set out in detail on 11 May 2015. It is summed up on page 7:

> This case is complex from almost any angle, but at its core is a single, simple question. Did the defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by these mortgages? Following trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measure, is enormous.

Because the case was brought on the grounds of strict liability, the FHFA only had to prove that there were factual errors in the offering documents and did not have to show negligence or fault. From the FHFA's point of view, this enabled the judge to rule out evidence involving Fannie and Freddie. For example, at one point reference is made to Nomura's attempts to work closely with the GSEs. That was in fact the GSEs *modus operandi*, working closely with the lenders from whom they bought loans and PLSs.

The fact that the case depended only on strict liability was overlooked in the headlines:

- 'misconduct' in the 08 Crash (*New York Times*);
- Nomura's "enormous" deception in the sale of defective mortgage-backed securities' (*Bloomberg*); and
- the New York Post said that Nomura "lied" about the MBSs it sold to Fannie and Freddie during the run-up to the financial crisis.

The judge herself may have come close to going beyond strict liability, when she stated that the supplements contained "utterly misleading descriptions of the quality and nature of the loans supporting the GSEs" certificates[31].

Judge Cote states that:

> […] given the magnitude of the falsity, it is perhaps not surprising that in defending this lawsuit defendants did not opt to prove that the statements in the Offering Documents were truthful […] instead they relied […] on a multifaceted attack on the plaintiff's evidence[32].

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That was both inevitable and appropriate, given that the FHFA's evidence was primarily based on the evidence provided by the two "experts". Other evidence which would have been relevant, that is, the whole context in which Fannie and Freddie purchased PLSs, the weakness and mismanagement on the part of senior executives of the GSEs and the extent to which they misled investors, was ruled out. That may be understandable given the selection of a strict liability approach. Strict liability also meant that there was no scrutiny of Fannie and Freddie's actions and their relationships with lenders, often stretching back over many years.

In the event, the judge made it plain during the court proceedings the extent to this she was impressed with Kilpatrick himself, as well as with the AVM he produced. The petition submitted by 11,000 appraisers in 2007 to Congress and the Appraisal Subcommittee of the Federal Financial Institutions Examination Council, complaining about the pressure by some lenders (or individuals within their ranks) to hit or exceed a predetermined value, requesting action. This led the FHFA to produce a Code of Conduct in 2008. This evidence was limited to the state of the mind of the appraisers (but not necessarily or at all) involved in the specific valuations of the properties of backing Nomura's PLSs. It was, as some of the witnesses pointed out, simply inevitable that appraisers would face such pressures and had done so for many years; hence, the need for appraisers to be independent of the lenders. From the existence of such pressures, it does not follow that all or even many of the appraisers succumbed. At best, this was simply hearsay evidence.

However, in the judge's view, the defendants' attack failed and judgement was entered in favour of the plaintiff. Nomura has stated that it would appeal against judge Cote's ruling. The headlines cited above may help to explain why the other banks chose not to go to trial and face further reputational damage as well as the costs and time taken for the trial to take place; in this case, from September 2011 to May 2015.

Part VI. The legal basis for the challenges

FHFA

The FHFA complaints against 18 banks were based on the claim that the representations made by the banks regarding the MBSs they sold to Fannie Mae and Freddie Mac were material to them as reasonable investors and that their falsity violated under various sections of the Securities Act, 1933, and under both the Virginia Code and the District of Columbia Code, which constitute common law negligent misrepresentation. The FHFA filed the complaints under the broad authority granted to it by HERA in 2008.

However, questions have now been raised over the extension of time given under HERA, which created the FHFA and gave it extra time for Fannie and Freddie claims. The defendants for the banks have argued that HERA only extended the Securities Act's one year statute of limitations not the law's three year statute of repose. The latter addresses the right of a defendant to be free from liability after a set amount of time. It places an outer limit on the right to bring a civil action. That limit is not measured from the date on which the claim accrues but instead from the date of the last culpable act or omission on the part of the defendant. Statutes of repose should ensure that the plaintiff brings an action in a timely manner. Statutes of repose bring about a legislative judgement that a defendant should be free from judgement after the legislatively determined period of time[33]. In a recent case, (CITS CORP v Waldburger, 9 June), the

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Supreme Court drew a clear distinction between the statutes of limitation and repose, for which the bank defendants in MBS litigation have argued. The Opinion states that:

> […] there is a considerable common ground in the policies underlying the two types of statute. But the time periods specified are measured from different points, and the statutes seek to attain different purposes and objectives.

However, a decision by Judge Alvin Thompson, a Connecticut federal judge, denied the Royal Bank of Scotland plc's attempt to set aside the FHFA's case against the bank on the grounds that a recent Supreme Court decision (CTS Corp v Waldburger in 2014) did not apply in this case. The Housing and Economic Recovery Act, which extends the time the FHFA has to file suits against companies regarding securities, is not affected by that case. Judge Thompson argued that HERA extends the time for FHFA to within three years of its creation in 2008 and it is expressly intended to apply to limitations as well as to the more restrictive statutes of repose. The judge also declined to grant RBS leave to appeal the decision, arguing that there was no substantial difference of opinion between the Supreme Court and the Second Circuit[34].

Part VII. The Fines agreed between the defendants and both the FHFA and the Department of Justice

It is not easy to estimate the total amount of the fines imposed on the banks, apart from those agreed with the FHFA. This is because some of the fines were imposed as a result of actions taken by the Department of Justice under the auspices of President Obama's Financial Fraud Enforcement Task Force and the RMBS Working Group, which involve over 20 federal agencies, 94 USA attorneys offices, state and local partners. The remit is to tackle fraud of all types, not just the fraud allegedly committed by banks, when they sold MBSs to Fannie Mae and Freddie Mac and other investors. Some of the fines imposed by the Department of Justice are not spelt out on their website and others are in great detail. Their focus is on the fines imposed on the leading banks; others are noted in press reports and others have yet to be finalised, as appears to be the case with Morgan Stanley. In its 10-K returns to the SEC in February:

The fines imposed by the FHFA

The FHFA announced the amount agreed in the PLS litigation settlements. By 2013, agreement had been reached with the following banks:

- General Electric Company – $6.25 million.
- Citigroup Inc. – $250 million.
- UBS Americas – $885 million.
- JP Morgan Chase & Co. – $4 billion.

The total fine imposed on JP Morgan amounted to $5.1 billion as the final figure included a resolution of "single family, whole loan representation and warranty claims", which was achieved at the same time[35]:

- Deutsche bank AG – $1.925 billion.
- Ally Financial, Inc. – $475 million.

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Other settlements took longer. In August 2014, Goldman Sachs agreed to pay $3.15 billion in connection with the releases and purchase of securities by Fannie Mae and Freddie Mac, according to the details of the complaint.

At the end of 2014, the FHFA reported on the other settlements:

- Morgan Stanley – $1.2 billion.
- SG Americas – $122 million.
- Barclays Bank PLC – $280 million.
- First Horizon National Corps. – $110 million.
- RBS Securities Inc. (in ally action) – $99.5 million.
- HSBC North American Holdings, Inc. – $550 million.
- Bank of America Corp., Merrill Lynch & Co. and Countrywide Financial Corporation – $5.83 billion.
- Wells Fargo Bank, N.A. (non-litigation) – $335.23 million.

The costs of settling the Nomura Holding America, Inc. and the Royal Bank of Scotland Group plc are, of course, still outstanding.

In the case of the FHFA, the fines were first used to reimburse Fannie and Freddie for the losses incurred by the GSEs or in the repurchase of the PLSs with the remainder going to the treasury.

The fines imposed by the Department of Justice

The details of the fines imposed by the Department of Justice were set out in the first article. The focus here is less on the amount but more on the distribution of the fines, and because this is provided for the fines imposed on the Bank of America and others, the details are provided here. They all follow a similar pattern.

$10 billion will be paid to settle federal and state civil claims relating to the packaging, marketing, sale, arrangement, structuring and issuance of RMBSs, CDOs and the underwriting and originating of mortgage loans.

$5 billion civil penalty to the Justice Department's claims under FIRREA, of which $1.03 billion will be paid to settle federal and state securities claims by the FDIC.

$134.84 million will be paid to settle claims by the SEC. Further payments will be paid to settle claims made by the states of California, Delaware, Illinois, Maryland, New York and the Commonwealth of Kentucky.

$7.5 billion to consumer relief and consumer tax bills. The relief will take various forms, including principal reduction loan modifications, so that many homeowners will no longer be underwater, leaving them with substantial equity in their homes. It will also include new loans to credit worthy borrowers struggling to get a loan, donations to assist communities in recovering from the financial crisis and financing for affordable rental housing. The Bank of America has agreed to place over $400 million in a tax relief fund to defray the tax bills that will be incurred by consumers receiving some type of relief, if Congress fails to extend the tax relief coverage of the Mortgage Forgiveness Debt Relief Act, 2007. These monies will go to delinquent borrowers in Cleveland, Atlanta, Philadelphia, Detroit and Chicago, amongst others. An independent monitor will be appointed to determine whether the Bank of America has met all its obligations. If it has not done so by 31 August 2018, then it must pay liquidated damages to in the

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amount of the shortfall to organisations that will use the funds for state-based Interest on Lawyers Trust Account organisations (providing legal aid) and to Neighborworks, a non-profit organisation that has large numbers of community development non-profits as its members. The monies would go to such organisations, primarily concerned with affordable housing, as are on the Department of Housing and Urban Development's approved list. NeighborWorks has received some $2 billion in aid since 2007. Counselling provided by Neighborworks and its members is designed to assist homeowners threatened with foreclosure to find the help they need, but according to Christy Romero, Special Inspector for the Troubled Asset Relief Programme, there is insufficient oversight on whether the funds targeted for saving homes are succeeding[36]. For the Department of Justice, funds are to be used for foreclosure prevention and community development, legal assistance, housing counselling and neighbourhood stabilisation[37].

Similar settlements were made with JP Morgan Chase and Citigroup. Total fees paid by the banks amount to $187 billion between 2009 and March 2015, with further settlements to come with Goldman Sachs, Morgan Stanley, Nomura and RBS.

Part VIII. The Whistleblowers

The Fraud Enforcement and Recovery Act provided further protections for whistleblowers (also called relators), an entirely acceptable move. However, the Department of Justice's website specifically calls for whistleblowers, provides information on the way in which the complaint should be made and also sets out the legislative protections. The DoJ has increasingly taken over cases brought by whistleblowers against banks, for example, reporting at least 700 whistleblowers in 2012 and 2013. Violation of the FCA carries a civil penalty of not less than $5,500 and no more than $11,000 for each claim.

More important, the FCA imposes liability equal to triple the amount of damages suffered by the government. The DoJ's decision to intervene in a qui tam action filed is a key indicator of the size of the recovery. The whistleblowers and their attorneys share in up to 30 per cent of any recovery in cases where the government does not intervene and from 15 per cent to 25 per cent of the money recovered if the government intervenes and takes control of the action. The whistleblower is also entitled to recover attorney fees and costs. For example, in May 2012, after the Justice Department's settlement with the nation's largest mortgage services, a single whistleblower received more than $18 million from the proceeds of the settlement. The other protections provided in the legislation hardly seem necessary for someone who would be set up for life after receiving such a payout! The trouble with such large sums being available is that it does raise questions about the role of the whistleblower.

Part IX. Some concerns about the complaints and the Fines

General issues

This account of the aftermath of the financial crisis highlights an important issue to be addressed: do the large fines imposed on the banks help to avoid another crisis or improve bank behaviour? Linked with this is the question which is often on many people's lips: why have no high-level executives been prosecuted? Before turning to the latter question, it should be noted that such fines can only begin to be effective if certain conditions are met. They are:

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- The fines must be imposed within the appropriate context and on the basis of laws and regulations, which were in place at the time when the offences were committed. In some of the cases outlined above, the context was ignored and relevant, even though the basis on the complaints were made, which were defined in such a way that the context was irrelevant.
- Not only should the laws and regulations be entirely clear but also the regulators should ensure that the banks concerned should understand both the extent of their lack of compliance and the reasons for the actions taken by the regulators. In many jurisdictions, the regulators would have the power to impose fines and other powers over the company and its senior executives.

Holding individuals responsible

In an interesting article, Judge Jed Rakoff, writing in the New York Review of Books[38], who describes a significant shift which has taken place over recent years; from "focussing on prosecuting high-level individuals to focussing on prosecuting companies and other institutions [...] the reasons are obvious. Companies do not commit crimes but only their agents do".

Prosecutors have presented this as "transforming the corporate culture". It has also given rise to the "deferred prosecution agreements" and non-prosecution agreements in which the company agrees to take various measures to prevent such occurrences in the future.

Rakoff also argues that the whole process of reaching an agreement with the company is:

> [...] technically and morally suspect because under law, unless you can prove beyond reasonable doubt that some managerial agent of the company committed the alleged crime; and, if you can prove that, why not indict the manager? And from a moral standpoint, punishing a company and its many innocent employees and shareholders for the crimes committed by some unprosecuted individuals seems contrary to elementary notions of moral responsibility.

This must be the principle underlying all prosecutions and enforcement actions against banks. However, even the pretence of improving the culture of the bank seems to have been cast aside in the actions taken against them by the FHFA and the Department of Justice. Freddie Mac's CEO, Donald H Layton, referring to a settlement between Freddie Mac and the Bank of America for $404 million, in this case, said, "We continue to make very good progress in recovering funds that were due to the tax payer, as well as resolving Freddie Mac's legacy repurchase issues[39]". The latest estimate of the total fines imposed on the banks is that it reached $220 billion by March 2015.

With regard to the Depart of Justice settlements, in particular, the alleged core is "defrauding the investors in securities transactions" Professor David Skeel, commenting on the Bank of America settlement, said:

> I understand the desire to help homeowners but litigation based on other wrongs seems to be a really indirect way of helping them. It's very political and a bit arbitrary.
>
> Probably my biggest concern is with the conflict of interests faced by both parties negotiating. The government has an incentive to collect a lot of fine revenue, and the bank executives to write large checks.

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Professor Bratton adds:

> The bum debt papers were generated by large institutions on a mechanised basis. The CEOs were too far away from the operations. They made bad business decisions but they were not criminal[40].

The point here is, if senior executives or those with oversight responsibilities are to be held accountable, then both laws and regulations must be clear. There must be a framework in which they can be held accountable and that they knew (or should have known what was happening) must also be proved. Just how that is to be achieved is one of the major issues facing financial regulation now.

Part X. A new policy on individual liability

This was announced on 9 September 2015 in a memorandum from the Deputy Attorney General, entitled "Individual Accountability for Corporate Wrong-doing[41]". The Department of Justice has faced widespread criticism for the failure to hold any senior executives to account. The reasons given for its change of heart are just the ones outlined here: holding individuals responsible will:

> […] deter future illegal activity, it incentivizes changes in corporate behaviour, it ensures that the proper parties are held responsible for their actions, and it promotes proper confidence in our justice system.

The memo acknowledges the "tension" between the requirement to return as much money to the treasury as possible and to hold culpable individuals to account. Clearly, the former requirement has been predominant in the aftermath of the financial crisis. The emphasis in the memo on the individual not on the amount of money does indicate a change of direction, but one which the Deputy Attorney General admits will be difficult to achieve. Of the policies set out in the memo, the one which is most likely to produce results is that no co-operation credit will be given to a company unless all the relevant facts about individuals involved in corporate misconduct are given to the DoJ.

Although the memo does set out a new approach, it is just a set of guidelines, not laws, sometimes only codifying what is already in place. It is not expected to apply to investigations that are already well under way; therefore, it may be sometime before any prosecutions of individuals take place. For it to succeed, more is required. That should consist of comprehensive requirements for senior managers setting out their responsibilities clearly in laws and regulations covering the banking sector. The question is: who is to blame for what – exactly? Without an answer to that question, senior executives are unlikely to end up in court.

Notes

1. The Complaints are set out in full in on the FHFA website. FHFA Filings in PLS cases. September 2, 2011.
2. The Uniform Standards of Professional Appraisal Practice issued by the Appraisal Institute (approved by Congress as the standard-setter) in its Q&A, issued on June 7, 2007, states that an "AVM's output is not by itself an appraisal and communication of an AVM's output is not by itself, an appraisal report".
3. *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare*, p. 311. See also, Wall Street and the Financial Crisis: The Role of the Credit Rating Agencies, Permanent

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Subcommittee on Investigations April 23 2010. SEC Summary Report of the Issues Identified in the Commission Staff Examination of Select Credit Rating Agencies (which includes Fitch), July, 2008.

4. Press Release, Department of Justice, February 5, 2013.
5. Justice Department and State Partners Secure $1.375 billion Settlement with S&P for Defrauding Investors in the Lead Up to the Financial Crisis, Feb 3, 2015.
6. *The Economist* a fine too far, February 4, 2015.
7. The Complaint against Bank of America and others, p. 38.
8. Washington Mutual Form 10-K, December 31, 2003.
9. Freddie Mac External Risk Group, "Subprime Market Share Strategy", Memorandum, August 2, 2005, p. 2.
10. Hidden in Plain Sight, Peter J. Wallison, p. 185. Letter from Sandra Fostek, HUD to Pamela Bank, Fannie Mae, September 30, 2005. The full letter can be read on the American Enterprise's Institute.
11. Letter dated December 21, 2007.
12. Statement of James Lockhart III, Director of the Federal Housing Finance Agency before the Senate Committee on Banking, Housing and Urban Affairs, on the appointment of the FHFA as Conservator for Fannie Mae and Freddie Mac, September 23, 2008, pp. 1-3. See also, *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare*, pp. 251-272.
13. Black Box Casino, pp. 168-170, based on interviews with James Lockhart.
14. December 18, 2014, the Court rejected evidence concerning the housing goals, p. 17 pf the Pretrial Memorandum.
15. In fact, Freddie Mac used exactly these arguments in defending itself in other lawsuits, such as Kuriakose v. Federal Home Loan Mortgage Corp., No 1:08 Civ. 07281, stating, "it is common knowledge that, beginning in the latter half of 2007, this country entered a period of unprecedented financial turmoil. Real estate values plummeted and credit markets froze. Just as (Freddie Mac) had warned investors, its financial results and its stock price suffered after those macroeconomic events unexpectedly tore through the US economy". The following pages of the Pretrial Memorandum, pp. 17-38 provides interesting details of the way in which Fannie Mae and Freddie Mac assessed the risks of a decline in the housing market and assessed the private label securities.
16. Op.cit, p. 45.
17. Op.cit, p. 47.
18. Op.cit, p. 52.
19. Court transcript, p. 282.
20. Kennedy's evidence. Court proceedings, p. 459.
21. Tax assessment valuations. The procedures for using these are set out on p. 134 of the Guidelines, including "determining and documenting how the tax jurisdiction calculates the TAV and how frequently property revaluations occur". Kilpatrick admitted that he did not carry out any such work.
22. pp. 157-160.
23. Proceedings of the Trial, p. 142.

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24. The credibility assessment model is examined in the court proceedings, pp. 176-200.
25. Court proceedings, p. 692.
26. Court proceedings, p. 695.
27. The cross-examination of Mr Hunter by Mr Tulchin can be found at pp. 600-612 and pp. 666-843 of the court proceedings and pp. 731-757 refers to the issue of owner occupancy. On p. 688, Mr Hunter advises, in response to Mr Tulchin's question that he was paid $1.5 million for the preparation and presentation of his evidence.
28. US Securities and Exchange Commission v. Richard F. Syron, Patricia L. Cook and Donald L. Bisenius, December 18, 2011, pp. 29-30.
29. Op.cit, p. 34.
30. p. 37.
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