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The impending put-back/law suit crisis in the mortgage bond industry

John Carney thinks the government won't let it happen, without explaining what it is. So let's go to Felix Salmon:

> You thought the foreclosure mess was bad? You're right about that. But it gets so much worse once you start adding in a whole bunch of parallel messes in the world of mortgage bonds. For instance, as Tracy Alloway says, mortgage-bond documentation generally says that if more than a minuscule proportion of notes in a mortgage pool weren't properly transferred, then the trustee for the bondholders can force the investment bank who put the deal together to repurchase the mortgages. And it's looking very much as though *none* of the notes were properly transferred.

The put back issue thus refers to the prospect that the purchasers of the bond may be able to rescind the transaction and put the bonds back to the banks. Carney dismisses this as a problem, because "the politicians will not let the financial stability of the largest bank in the nation be threatened by contractual rights."

> Here's what is going to happen: Congress will pass a law called something like "The Financial Modernization and Stability Act of 2010" that will retroactively grant mortgage pools the rights in the underlying mortgages that people are worried about. All the screwed up paperwork, lost notes, unassigned security interests will be forgiven by a legislative act.
>
> There's a big difference between the financial crisis of 2008 and the new crisis. In 2008, banks were destabilized by the growing realization that they were over-exposed to the real estate market. Huge portions of their balance sheets were committed to mortgage-linked investments that were no longer generating the expected revenues or producing losses. That was a problem of economics that could only be solved by recapitalizing banks or letting some of the biggest banks in the U.S. fail.
>
> The put-back crisis is not driven by economics. It is driven by legal rights. And there's simply zero probability that the politicians in Washington are going to let **Bank of America** or **Citigroup** or **JP Morgan Chase** fail because of a legal issue.
>
> So here's what I expect will happen. The lame duck session of Congress will pass a bill that essentially papers over the misdeeds of the banks that originated mortgage securities. Every member of Congress and every Senator who has been voted out of office will cast a vote for the bill. And the President will sign it.

He's probably right. But there's another problem lurking out there. Back to Salmon:

> It also turns out that there's a pretty strong case that they lied to the investors in many if not most of these deals.
>
> I mentioned this back in September, and I've been doing a bit more digging since then. And I'm increasingly convinced that the risk to investment banks isn't only one of dodgy paperwork; there's also a serious risk of massive lawsuits from the SEC or other prosecutors, as well as suits from individual mortgage investors.

Salmon goes on to detail the disclosure issues. Personally, I doubt very much that even the most massive litigation mess of all time would create a serious financial crisis of the sort we experienced in 2008. But it does go to show the extent to which mass financial torts now adversely affect American business.

The private party securities fraud class actions that will result if Salmon is right are the real problem.

The vast bulk of recoveries in class asctions historically have been paid either by issuers or their insurers, rather than by individual defendants. As a result, any recovery by investors typically comes out of the corporate treasury, either directly or indirectly in the form of higher insurance premia. In either case, these payments reduce the value of the residual claim on the corporation's assets and earnings. In effect, the company's current shareholders pay the settlement, not the directors or officers who actually committed the alleged wrongdoing.

The effect of securities class actions thus is a wealth transfer from the company's current shareholders to the injured investors. In the case of a diversified investor, such transfers are likely to be a net wash, as the investor is unlikely to be systematically on one side of the transfer rather than the other. Because there are substantial transaction costs associated with such transfers, moreover, the diversified investor is likely to experience an overall loss of wealth as a result of the private securities class actions. Legal fees to plaintiff counsel typically take 25-35% of any monetary class action settlement, for example, and the corporation's defense costs are likely comparable in magnitude.

All of which is why litigation reform remains a pressing issue.

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'd be interested in your thoughts on mortgage-bond fraud, in particular, and private suits. If the threat of private suits had deterred the banks from selling fraudulent securities, we would have avoided a massive recession. That would have made all the lawyer fees for private suits, trivial by comparison, worthwhile.

The odd thing is that we have silly private suits for drops in stock prices, but not for sales of fraudulent securities by one company to another. Why is that? I should think juries at the moment would be very kind towards plaintiffs in such cases.

Posted by: Eric Rasmusen | 10/20/2010 at 06:23 PM

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