BLB&G

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Subprime Mortgage Meltdown: The Risks to Institutional Investors

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"Somebody should write a book saying 'This Time It's Different' because that's always the buzzword….The greed for a little bit of extra return overwhelms normal risk management processes, and people extend credit in an untoward manner. It always has the same ending, with a lot of defaults…."

*-Renowned financier and distressed debt investor **Wilbur Ross** on the sub-prime mortgage debacle and resulting credit crunch (Financial News, 17 September 2007)*

Let the Good Times Roll…

- From roughly 2004 to 2007, subprime lending – higher interest loans to consumers with impaired or thin credit – was the fastest growing segment of the mortgage industry.

- Large Wall Street firms enjoyed record breaking earnings in recent years, fueled — in part — by fees related to the subprime mortgage market and by their own trading and holdings in these securities.

	Total Net Income ($ Bill)			
	2004	**2005**	**2006**	**2007**
Merrill Lynch	4.44	5.12	7.50	-8.60
Goldman Sachs	4.55	5.63	9.54	11.60
Lehman Brothers	2.37	3.26	4.01	4.19
Morgan Stanley	4.49	4.94	7.47	3.21
JPMorgan Chase	4.47	8.48	14.44	15.4
Bear Stearns	1.34	1.46	2.05	0.23
UBS	7.79	10.66	10.46	8.07
Citigroup	17.05	24.59	21.54	3.90
Totals	46.49	64.14	77.01	38.00

RMBS vs CDOs vs CDO^2

- **RMBS.** A type of mortgage backed security backed by a variety of non-commercial mortgage debt. Residential mortgages of varying credit quality are pooled together and sold in tranches* to investors looking to diversify their portfolios or hedge against certain types of risks.

- **CDO (Collateralized Debt Obligation).** A security backed by a pool of other securities. Although the collateral for CDOs can by composed of any type of loans or bonds, the CDOs issued in recent years frequently were backed exclusively by subprime RMBS. Through senior/subordinated structuring, CDOs are divided into tranches that absorb different levels of default and delinquency risk.

- **CDO^2 (CDO Squareds).** A security backed by the lower rated tranches of CDOs that have been re-pooled and "re-senior-subbed" to create AAA-rated securities out of lower rated collateral.

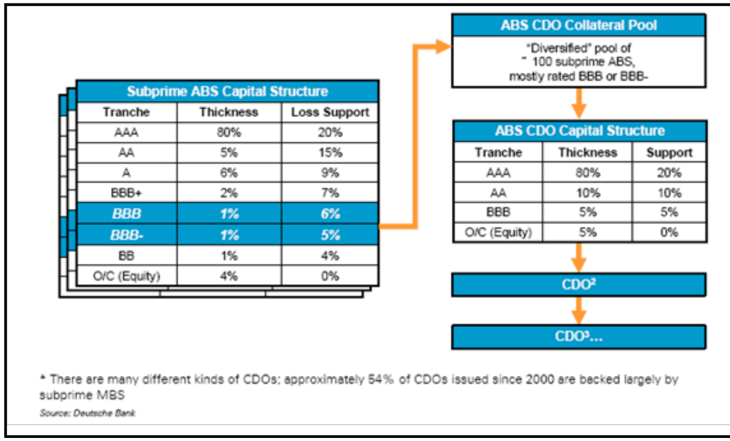
* Specific classes of bonds within an offering wherein each tranche offers varying degrees of credit or term risk to the investor.

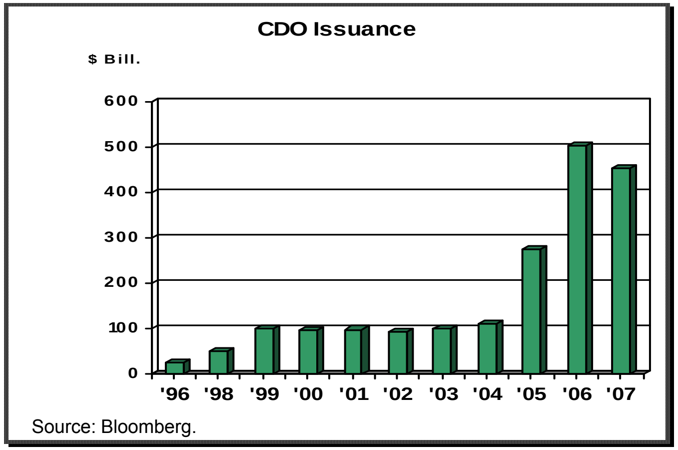
RMBS and CDO Issuance Explodes

- Subprime lenders sell pools of mortgages to investment banks in order to generate liquidity needed to issue additional loans.

- These pools are then structured into RMBS by the banks. The securities are carved into tranches -- each of which has different credit risk level and/or term.

- A strong market developed for CDOs. CDO sales reached $503 billion in 2006.





The warnings were there if you were listening:

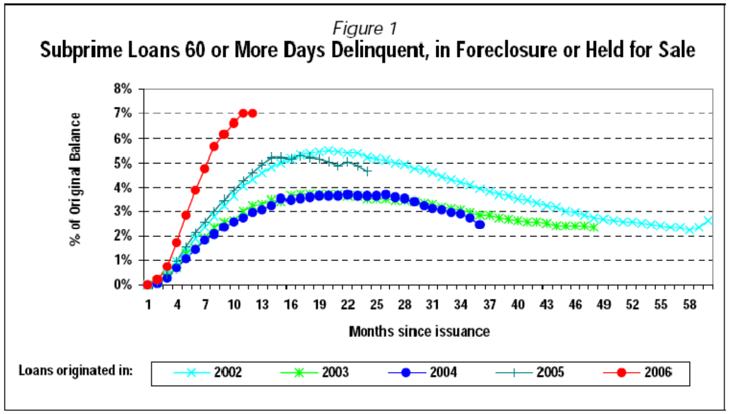
"The new layering of risk in mortgage loans and the introduction of new products to higher-risk profile customers is unprecedented, and these loans' credit performance is untested in weaker housing markets."
Standard & Poor's, November 30, 2005

Too Good to be True

- In the struggle to maintain volume and profits amid stiff competition, many mortgage banks relaxed lending standards in irresponsible ways.
- We are now currently seeing record defaults and delinquencies particularly in the huge 2006 loan cohort.

Fun Facts:

- **Subprime Mortgages with resets in Jan – Aug 2008: <u>$192 Billion</u>**
- **Percentage of those loans with LTVs >90%: <u>40%</u>**



The Subprime Sector Melts Down

Over the spring and summer of 2007, the lax practices of many mortgage lenders came to light. Common themes include:

- Failure to maintain lending standards
- Failure to disclose rising defaults, loan buy-back requirements or exposure to other struggling firms
- Inadequate loan loss reserves
- Overly optimistic forecasts regarding housing prices and potential defaults
- Insider trading by officers and directors as impairment of business model became apparent.

The news of the lax standards and the predicted looming defaults limited the largest mortgage lenders in their ability to finance their operations or sell their loans down the pipeline, and their stocks declined precipitously. Some former high flyers forced into bankruptcy.

Numerous securities class actions on behalf of investors have ensued against major subprime lenders such as:

- New Century Financial Corporation
- Accredited Home Lenders Holding Company
- Countrywide
- American Home

Investment Banks, Ratings Agencies All Complicit

- Subprime collapse is a result of failures in standards and due diligence by more than just the mortgage lenders.
- Continuing revelations of misconduct by investment bankers and rating agencies are now starting to wend their way through the US economy. The negative spiral of declining home values and increasing defaults and delinquencies is causing recessionary pressures.
- The rating firms have already downgraded more than $50 billion worth of MBS in the past few months. Moody’s alone cut, or said it was likely to cut, credit ratings on scores of CDOs, some of these CDOs were cut from the highest possible “AAA” ratings to “junk,” an especially noteworthy step.
- Bond insurers such as MBIA, AMBAC and ACA also appear to have badly misjudged the risk inherent in the mortgages and to have concealed their exposure levels.

Banks Report Historic Write-downs… Shareholders are Crushed… But Bonuses Soar?

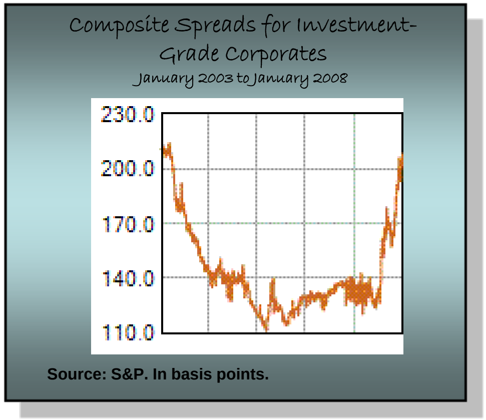
- Throughout the second half of 2007, the largest investment banks begin to announce multibillion-dollar write-offs.
- Shareholders in these banks suffer massive losses - over $200 billion is lost in market cap. through Dec. 2007.
- Caught without adequate firm-wide risk controls, the banks admit to multiple sources of mortgage exposure from warehousing loans, proprietary trading, and writing credit-default swap contracts.
- Sovereign wealth funds have injected tens of billions in capital into the banks, buying US assets at bargain-basement valuations.
- Astonishingly, the top 5 investment banks (Merrill Lynch, Goldman Sachs, Lehman Brothers, Morgan Stanley, & Bear Stearns) are still paying an estimated $39 billion in bonuses.

(**Source:** *Bloomberg,* January 17, 2008)

	2007 Writedowns (in billions)	2007 Change in Share Price	Lost Market Capital (in billions)
Merrill Lynch*	24.5	-42%	$32.4 B
Goldman Sachs	0	Flat	$0
Lehman Brothers	1.5	-16%	$6.4 B
Morgan Stanley	9.4	-35%	$14.2 B
JPMorgan Chase*	3.2	-10%	$10.8 B
Bear Stearns	2.6	-46%	$9.9 B
UBS	14.4	-24%	$27.2 B
Citigroup*	22.1	-47%	$118.9 B
***Source Bloomberg.**			

Spillover Effects

- The subprime meltdown has led directly to declines in the stock markets.
- More subtly, declining housing values are putting at risk other entire lines of business within the banks.
  - HELOCs and second liens declining in credit quality as home values depreciate.
  - As overstretched consumers struggle with bloated mortgage debt, credit card default and delinquency figures are rising.
- Bond valuations plummet as participants reprice.
  - Credit risk is market wide -- *not just in financial names*.



Still to come…

- Questions remain about how much the banks are not still not disclosing.

- The teetering status of the monoline bond insurers is a further source of potential instability. If the major firms lose their AAA status, investors, including the banks, will be forced to take further cuts in marked-to-market valuations of mortgages and additionally, trillions in muni bonds.

- Possible undisclosed exposure within the GSEs (government sponsored enterprises such as Freddie Mac and Fannie Mae) is rumored.

Quote of the Week:

"In the end, the story of 2008, 2009 and possibly 2010 will be the extent and consequences of what promises to be the worst US housing correction since the Great Depression."

Jack Malvey, Chief Global Fixed Income Strategies, Lehman Brothers.

"Conservative placements?" Institutional Investors Need to be Concerned

- It appears that financial institutions have concealed their exposure to losses from MBS, CDO and other financial instruments tied to the performance of these investment vehicles.

- It has also recently come to light that respected institutional investment managers have been improperly placing clients' portfolio holdings in high risk mortgage backed securities and exotic financial instruments.

Potential Litigation

In order to determine whether your institution has incurred a loss caused by exposure to subprime mortgages, you must first determine whether your institution:

- Is invested in the shares of mortgage lenders that have been the target of a securities class action suit;
- Is invested in the shares of investment banks with significant exposure to subprime mortgage-backed securities;
- Has invested directly in CDOs; or
- Is invested in any funds or investment vehicles that invest in CDOs.

Depending on the specific investments made by each fund and particulars of its losses, claims may need to made against:

- Subprime lenders
- Investment banks
- Investment advisors
- Rating agencies
- Hedge funds and other investment vehicles

The Importance of Portfolio Monitoring

In order to know about cases in time to take action within the PSLRA's 60-day window, a fund should have an established mechanism in place.

- It is essential to know early that you have sustained a significant loss
- Newly-filed cases are systematically cross-referenced against securities trading in institutional portfolios
- Qualified counsel will normally provide this service at no cost if given access to portfolio

The Mechanics of Portfolio Monitoring

Portfolio Monitoring utilizes direct electronic access to the client's custodial accounts for the purposes of:

- ***Tracking***: Tracking portfolio trades and cross-referencing them against potential securities claims.
- ***Customization***: Tailored content and frequency of written reports and presentations to the specific needs of a given investor.
- ***Analysis***: Detailed analysis of the facts regarding a potential claim within the strict time limits of the PSLRA.
- ***Legal Counseling***: Counseling clients on when to pursue litigation, and -- equally important -- *when not to*.

What have we learned… again?

-- The S&L Crisis

-- Enron

-- The Tech Bubble

If it feels like a pyramid and acts like a casino, its probably both.