A.G. SCHNEIDERMAN SUES JPMORGAN FOR FRAUDULENT RESIDENTIAL MORTGAGE-BACKED SECURITIES ISSUED BY BEAR STEARNS

First Legal Action Of State-Federal Residential Mortgage-Backed Securities Working Group Created By President Obama

Lawsuit Charges Bear Stearns Misrepresented Quality Of Loans, Deceived Investors & Contributed To Mortgage Crisis

Bear Stearns RMBS Trusts Incurred Billions In Losses

Tuesday, October 2, 2012

WASHINGTON – In his role as co-chair of the Residential Mortgage-Backed Securities Working Group, Attorney General Eric T. Schneiderman today announced a Martin Act lawsuit against J.P. Morgan Securities LLC (formerly known as Bear Stearns & Co. Inc.), JP Morgan Chase Bank, N.A., and EMC Mortgage LLC (formerly known as EMC Mortgage Corporation) for making fraudulent misrepresentations and omissions to promote the sale of residential mortgage-backed securities (RMBS) to investors. According to Attorney General Schneiderman's lawsuit, these defendants deceived investors as to the care with which they evaluated the quality of mortgage loans packaged into residential mortgage-backed securities prior to Bear Stearns & Co's collapse in early 2008, incurring losses that have totaled approximately $22.5 billion to date.

Attorney General Schneiderman's lawsuit is the first legal action from the RMBS Working Group, a state-federal task force created by President Obama earlier this year to investigate those responsible for misconduct contributing to the financial crisis through the pooling and sale of residential mortgage-backed securities.

“This lawsuit will bring accountability for the misconduct that led to the crash of the housing market and the collapse of the American economy,” said Attorney General Schneiderman. “Our lawsuit demonstrates that there is one set of rules for all – no matter how big or powerful the institution may be – and that those rules will be enforced vigorously. We believe that this is a workable template for future actions against issuers of residential mortgage-backed securities that defrauded investors and cost millions of Americans their homes. We need real accountability for the illegal and deceptive conduct in the creation of the housing bubble in order to bring justice for New York's homeowners and investors.”

RMBS Working Group members contributed significantly to this effort. The Federal Housing Finance Agency Inspector General played a key role working with the New York Attorney General's Office on the investigation, providing investigators and lawyers, the U.S. Securities and Exchange Commission collaborated and assisted with the case, while the Department of Justice provided resources from U.S. Attorney's offices around the country to assist with interviews and depositions.

"Fannie Mae and Freddie Mac purchased residential mortgage-backed securities from the defendants and were allegedly misled about the quality of the loans supporting those securities. Actions like this contributed to the financial crisis and those who engaged in such activities should be held accountable," said FHFA Inspector General Steve Linick. "My office has worked and continues to work very closely with the RMBS Working Group and the New York Attorney General's Office in support of the investigation and prosecution of RMBS fraud cases."

"This announcement demonstrates that the RMBS Working Group model works," said RMBS Co-Chair and U.S. Attorney for the District of Colorado John Walsh. "The Department of Justice, including U.S. Attorney's Offices across the country, the Office of the Inspector General for the Federal Housing Finance Agency and the SEC were proud to offer their extensive expertise and commit substantial resources in order to assist the New York Attorney General's efforts. This filing is a testament to the unity of purpose brought to bear by the RMBS Working Group and what is possible when we work together to achieve justice for all Americans."

According to Attorney General Schneiderman's complaint, Bear Stearns led its investors to believe that the quality of the loans in its mortgage-backed securities had been carefully evaluated and would be continuously monitored. In fact, Bear Stearns did neither. Instead, it systematically failed to evaluate the loans, largely ignored defects that its limited review did uncover, and kept its investors in the dark about the inadequacy of the review procedures and defects in the loans. Even when Bear Stearns executives were made aware of these problems, the company failed to reform its practices or disclose material information to investors. As a result, the loans in Bear Stearns's mortgage-backed securities included many that had been made to borrowers who were unable to repay the loans, were very likely to default, and ultimately did default in large numbers.

As explained in the complaint, filed in New York State Supreme Court late Monday, residential mortgage-backed securities were pools of mortgages deposited into trusts. Shares of the RMBS trusts were sold as securities to investors, who were to receive a stream of income from the mortgages packaged in the RMBS. In registration statements, prospectuses, prospectus supplements, term sheets, and other securities filings and marketing materials, defendants led investors to believe that they had carefully evaluated—and would continue to monitor—the quality of the loans in the RMBS.

The Attorney General’s lawsuit charges that Bear Stearns failed to abide by its representations that the loans underlying their RMBS were originated in accordance with the applicable underwriting guidelines, i.e., the standards in place to ensure, among other things, that loans were extended to borrowers who demonstrated the willingness and ability to repay. Further, while the defendants claimed that they undertook “due diligence” to ensure that the loans they purchased from originators complied with the relevant guidelines, they in fact, routinely overlooked defective loans that were identified through the due diligence review and ignored deficiencies that they knew existed in the due diligence review process itself.

Bear Stearns was well aware that its due diligence processes were fundamentally compromised by the massive number of loans that the company sought to have reviewed in very short periods of time. The corporation’s need to maintain business relationships with American Home Mortgage and other mortgage originators created a strong incentive for it to limit the number of defective loans that were eliminated from any given pool. Even when these flawed processes did identify defective loans, Bear Stearns nonetheless routinely overlooked negative findings and continued to package the loans into securities for sale to investors.

Bear Stearns also operated a “quality control” (QC) department that was supposed to detect red flags in the loans post-securitization and determine whether the loans complied with underwriting guidelines. Although the QC department was supposed to identify and correct problems in the underlying loans, and in appropriate circumstances pursue repurchases of the loans by the originators, the department was so overwhelmed that it essentially could not function. Bear Stearns was aware that the QC department was in “crisis” but took no action to reform the quality control process. In addition, even when the QC department identified serious problems, Bear Stearns entered into settlements that benefited loan originators at the expense of investors. Bear Stearns disclosed none of these problems or practices to investors.

Defendants were the sponsor and underwriter of an astounding number of securitizations that have gone sour. For example, as of August 2012, the cumulative losses suffered by investors in 103 subprime and Alt-A securitizations that Bear Stearns sponsored and underwrote in 2006 and 2007 totaled approximately $22.5 billion, or approximately 26% of the original principal balance of $87 billion.

Another $30 billion in unpaid principal on mortgages remain in these trusts today. 43% percent of that amount, or $12.9 billion is currently 90 days past due, in foreclosure, in bankruptcy or considered real estate owned by a bank (REO). This means current investors are likely to suffer additional losses going forward. The Attorney General seeks investor damages to recoup losses, as well as other equitable relief.

Today’s action is the latest part of Attorney General Schneiderman’s multi-pronged strategy to stem foreclosures, provide relief to struggling homeowners and hold accountable those responsible for the mortgage crisis.

Earlier this year, Attorney General Schneiderman was appointed by President Obama to co-chair the Residential Mortgage-Backed Securities Working Group. This joint investigation brings together the Department of Justice (DOJ), Department of Housing and Urban Development, the Securities and Exchange Commission (SEC), Federal Housing Finance Agency Office of Inspector General (FHFA OIG) and other agencies to investigate those responsible for misconduct contributing to the financial crisis through the pooling and sale of residential mortgage-backed securities. It builds upon ongoing state and federal investigations, while also launching new ones.

The investigation was conducted by Assistant Attorneys General Desiree Cummings, Tanya Trakht, Amir Weinberg, and Girolamo Brunetto, under the supervision of Deputy Attorney General Virginia Chavez Romano. The Attorney General also received substantial support from the FHFA OIG during the course of the investigation.

A copy of the lawsuit is available online at: www.ag.ny.gov/sites/default/files/press-releases/2012/jpmcomplaint.pdf

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