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Legal responses to the credit crisis: Will the UK follow the US?

A round-table discussion with Eric Foster and Talcott Franklin (Patton Boggs) and Shane Gleghorn (Taylor Wessing) held Tuesday, July 15, 2008, at Taylor Wessing, Carmelite, 50 Victoria Embankment, Blackfriars, London EC4Y 0DX from 12:30-2:15pm.

With support from Taylor Wessing

Is the country that brought mortgage securitisation and the credit crunch to the world about to export legal innovation to the UK as well? The first speaker set out the broad context in the US, starting with the general drive towards home ownership as a public policy goal, which in turn led to the securitisation of mortgages and the creation of Freddie Mac and Fannie Mae, the government-sponsored enterprises (GSEs) to guarantee them. The S&L crisis of the 1980s led to the creation of the repos market and the tax regime built around that that was exported to the rest of the world.

Several members were interested in the federal action to support Fannie Mae and Freddie Mac that was unfolding as the roundtable took place. The speaker said each had \$1 trillion of outstanding debt. The Federal government had tried to have its cake and eat it – the implied government guarantee kept their bond spreads low even as it denied any explicit guarantee. July's package of unlimited liquidity and potential for equity purchases has settled that issue. In terms of future rescues, bankers should keep their eye on Farm Credit and Sallie Mae even though the latter is no longer a GSE.

The second speaker said the drive for home ownership had regrettably been accompanied by a loosening in credit standards. He went through a series of laws that made it easier for institutions to sell, and borrowers to buy, mortgage products. It culminated in the Home Ownership and Equity Protection Act (HOEPA) that excluded adjustable rate mortgages (ARMs – the key to the subprime crisis) from its controls on abusive practices in connection with high-cost mortgages. ARM lending soared from \$400bn in 2001 to \$1.3 trillion in 2006. Now that the securitisations and the mortgages they were based on have turned sour, litigation is coming down the pipeline. The first group is between borrowers and securitisation trusts. Here there are signs of judicial activism as judges who don't understand securitisation and demanding affidavits and full documentation showing ownership of the property are throwing foreclosure suits out of court. Admittedly it is a small sample as most cases are uncontested but lenders need to start doing their legal homework before going to court, the speaker said. Meanwhile borrowers are suing lenders either for discrimination – alleging lenders pushed certain ethnic groups into subprime mortgages – or for violation of state laws.

There are also lawsuits between servicers, who deal with borrowers, and trustees, who act for the trusts, where there are doubts over who is obliged to perform certain duties. Lastly there are legal issues around the trust certificate holders particularly when a trust settles over a loan repurchase but is unclear how the money should be distributed.

The most interesting area is legal action outside the securitisation trusts. For example shareholders are suing companies that invested in subprime-backed products. Perhaps the most interesting is an action by the city of Cleveland against 30-plus lenders for a "public

nuisance” of irresponsible lending practices that caused a subprime lending and foreclosure crisis that left homes abandoned that the city must demolish and repair. Baltimore is suing Wells Fargo for alleged racial discrimination while Buffalo is suing 40 lenders for abandoning foreclosed properties. The criminal authorities are also stepping up to the plate with a flood of indictments of people involved in subprime.

There is also a backlash against regulators. The Office of Thrift and Supervision and the Office of the Comptroller of the Currency have been accused of “recruiting” banks because they earn revenues from those they regulate. Generally regulators are blamed for allowing an explosion in subprime lending from \$35bn in 1994 to \$660bn in 2006. The speaker warned credit card securitisation could be the next domino to fall - and it could be worse given there is no underlying collateral.

But does any of this apply to the UK? The third speaker thought not. A major obstacle was the fact that class actions were harder to mount. In the US class members do not have to pay legal fees even if they lose and are also assumed to have joined the action unless they opt out. In the UK the loser pays and each class member has to opt in. In terms of repossessions, members of the Council of Mortgage Lenders have agreed to the concept of the “pre-action protocol” that court action is only pursued when all other measures to help the borrower have failed. A Cleveland-style case seems impossible to mount in the UK.

Courts have tended to take a “black letter” view of issues such as disclaimers in securitisation deals, making mis-selling actions less likely to take off. In JP Morgan vs Springwell the High Court affirmed the principle of *caveat emptor* in the capital markets. However there are some points to bear in mind. There is academic discussion about changing the rule on class actions from opt-in to opt-out. However the big shift – from loser-pays to no-win, no-fee – is unlikely as there is support for its role of preventing opportunistic actions. There is also potential for legal innovation, for example over section 90 of the Financial Services and Markets Act that opens the way to legal action over misleading prospectuses. So while overall institutions can take some solace, no one should assume that English lawyers will not seek to emulate their American cousins.