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Morgan Stanley to Pay \$102 Million for Role in Massachusetts Subprime Mortgage Meltdown U

Martha Coakley

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The Official Website of the Attorney General of Massachusetts

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June 24, 2010 - For immediate release:

Morgan Stanley to Pay \$102 Million for Role in Massachusetts Subprime Mortgage Meltdown Under Settlement with AG Coakley's Office

Following AG Investigation, Investment Giant To Provide \$58 Million In Relief To 1000 Massachusetts Homeowners And Return \$19.5 Million To Massachusetts Taxpayers;

During Economic Crisis, AG Coakley's Office has secured more than \$440 million in relief for investors and borrowers, ensured mortgage relief for more than 15,000 homeowners in Massachusetts, and recovered more than \$50 million in taxpayer funds for Commonwealth

BOSTON – Investment giant Morgan Stanley (Morgan) will pay \$102 million to affected Massachusetts homeowners and the Commonwealth following an investigation by the Attorney General's Office into Morgan's role in the securitization and financing of Massachusetts subprime loans, Attorney General Martha Coakley announced today.

Listen to audio of today's press conference and view transcript:

- [Morgan Stanley press conference audio](#)
- [Morgan Stanley press conference transcript](#) **PDF**

View photos of today's press conference:

- [Morgan Stanley press conference photos](#)

View PDF of the Assurance of Discontinuance:

- [Assurance of Discontinuance filed June 24, 2010](#) **PDF**

View PDFs of supporting documents:

- [Morgan Stanley settlement state map](#) **PDF**
- [Morgan Stanley settlement chart](#) **PDF**

Under today's agreement, filed today in Suffolk Superior Court, Morgan will provide substantial relief to affected parties in Massachusetts, including \$58 million in relief to more than 1000 Massachusetts homeowners, \$23 million to the Massachusetts Pension Fund for investment losses, and \$19.5 million in taxpayer money to the Commonwealth's General Fund.

"This has become an all-too-familiar pattern in which the deceptive practices of Wall Street devastated homeowners and investors, and ultimately contributed to the collapse of our economy," AG Coakley said. "Our extensive investigation revealed that Morgan Stanley not only backed loans for homeowners that they should have known were destined to fail, they also caused additional damage in the subprime marketplace. Through today's action, we have secured significant relief to help keep hundreds of people in their homes and also recovered nearly \$20 million for Massachusetts taxpayers."

As a result of a lengthy investigation, the Attorney General's Office alleged that Morgan entered the subprime arena in Massachusetts by offering funding to retail lenders that specialized in loans to less-qualified borrowers. Morgan provided billions of dollars to subprime lender New Century, which used Morgan funds to target lower-income borrowers and lure them into loans that consumers predictably could not afford to pay. These loans often were unsustainable because of payment shock or poor underwriting, but were lucrative for subprime lenders, who generated fees and could expect that borrowers would have to refinance in the short term or face foreclosure. Some Morgan Stanley investment bankers referred to New Century as Morgan's "partner" in the subprime lending business.

In addition to the \$102 million in financial compensation, the settlement also requires Morgan to change its business practices going forward and to provide information and materials needed in the Attorney General's ongoing investigation of the subprime securitization marketplace.

Today's settlement is the latest in a series of actions brought by the Attorney General's Office in response to the economic and lending crisis. AG Coakley's Office has been a national leader in bringing actions on behalf of homeowners and taxpayers against companies relating to their role in the subprime marketplace, including Goldman Sachs, Fremont General, Countrywide, and State Street Bank. As a result of these actions, AG Coakley's Office has secured more than \$130 million in relief to investors and borrowers, ensured mortgage relief to more than 15,000 homeowners in Massachusetts, and recovered more than \$50 million in taxpayer funds returned back to the Commonwealth.

Allegations in the Assurance of Discontinuance, filed today in Suffolk Superior Court, include that Morgan provided funding, known as "warehouse lending" services, to New Century, which New Century in turn used to fund an ever increasing number of subprime loans. After New Century made the loans, Morgan would place the loans into a securitization pool, and then act as the underwriter selling investments backed by the subprime loans in the pool.

As part of this securitization process, Morgan employed third party due diligence providers to review the quality of New Century's loans. During this review, Morgan learned:

- New Century repeatedly violated the Massachusetts Division of Banks' "borrower best interest" standard when it made subprime loans, and thus made loans that violated Massachusetts law.
- New Century calculated the Debt to Income (DTI) ratio for borrowers based only on the initial "teaser rate" for the loans, rather than the fully indexed interest rate that would kick in after the teaser period expired. When calculated using the fully indexed rate, almost 40% of the loans failed Morgan's own internal underwriting standards for whether the borrower could pay them.
- The large majority of New Century loans failed the basic test of their own underwriting guidelines and could only be approved as "exception" loans, which required the presence of "compensating factors." Sample reviews by Morgan vendors showed that many of these loans violated the guidelines in several different ways, and about one-third of the randomly sampled loans lacked compensating factors to justify the extension of credit.
- Appraisals used by New Century to value the collateral backing the loans (the homes) were often significantly different from the Broker Price Opinions ("BPOs") that Morgan obtained to check New Century's figures. Appraisals are important because home value and the resulting loan-to-value ratio are key factors in assessing the riskiness of loans. Inflated or inaccurate appraisals create a heightened risk that the loans are prone to failure.
- New Century originated a large number of "stated income loans." These are loans that lack basic supporting paperwork to document the income and other figures often placed on loan applications by mortgage brokers, borrowers, or originators. New Century relied significantly on these loans. In fact, a Morgan employee noted that New Century overused stated income loans to the point of abuse.

All of these due diligence discoveries underscored the riskiness and/or uncertainty relating to New Century's loans and whether borrowers would be able to pay them back. It is illegal under Massachusetts law to make loans without reasonably assessing a borrower's ability to pay the loan according to its terms.

In late 2005 and early 2006, Morgan began rejecting greater numbers of New Century loans as a result of the due diligence findings. After New Century suggested it would shift its business elsewhere, Morgan began again to include a wider range of New Century loans in its purchase pools. A Morgan Stanley senior banker purchased loans that Morgan's own internal due diligence team initially rejected, and Morgan waived vendor concerns regarding a substantial number of the New Century loans identified as having material problems.

Moreover, as New Century finally spiraled towards bankruptcy, its risky lending practices exposed to the public, Morgan Stanley continued to lend money to the subprime originator even when other banks would no longer provide New Century with cash. During early March 2007, Morgan Stanley provided millions of dollars that New Century used directly to finance a last round of unsustainable predatory loans in Massachusetts.

Throughout 2006 and the first half 2007, Morgan continued to securitize New Century's predatory subprime loans, and sold investments to two Massachusetts state entities—the Massachusetts Pension Reserves Investment Trust (PRIT) and the Massachusetts Municipal Depository Trust (MMDT). This led to state funds being used to fuel predatory subprime lending, and to significant losses for PRIT and the MMDT.

Under the terms of today's settlement, Morgan will make the following payments and conduct reforms:

- Pay \$58 Million in principal reduction and related relief to over 1000 Massachusetts subprime borrowers
- \$19.5 Million payment to the Commonwealth
- \$23.4 Million to PRIT and the MMDT

- \$2 Million to non-profit groups throughout the Commonwealth to assist victims of subprime foreclosure
- Not fund unfair subprime loans in Massachusetts
- Make additional disclosures to Massachusetts investors regarding its future subprime securitizations
- Provide documents and information to the Attorney General's Office in its ongoing review of industry subprime securitization practices.

The resolution follows a similar matter in May 2009 against [Goldman Sachs](#), in which the Attorney General's Office recovered \$60 million in relief for the Commonwealth and over 700 affected Massachusetts homeowners. Also in 2009, the Attorney General reached a settlement with Fremont Investment & Loan, which included a permanent injunction restricting foreclosures and a \$10 million payment for consumer relief, civil penalties and costs, and in March 2010 agreed to broad borrower relief with Bank of America concerning Countrywide-originated loans. The Attorney General's Office has previously completed other investigations relating to the current economic crisis, and in 2008 recovered over \$75 million from resolutions with UBS, Morgan Stanley, Citibank, and Merrill Lynch regarding their sale of auction rate securities to Massachusetts towns, cities, and governmental entities. The Attorney General's Office also worked jointly with the SEC on a review of State Street's undisclosed subprime investments in 40 State Street Bond Funds, resulting in a nationwide recovery of over \$300 million for investors.

Homeowners with questions about today's settlement should contact the Attorney General's Insurance and Financial Services Hotline at 1-888-830-6277.

The Morgan Stanley matter is being handled by the staff of Attorney General Coakley's Insurance and Financial Services Division, including Division Chief Glenn Kaplan, and Assistant Attorneys General Aaron Lamb, Amita Singh and Peter Leight, as well as Legal Analyst Matt Gendron, Economist Bryan Lincoln, Mathematician Burt Feinberg, and Paralegals Cassidy Fitzpatrick and Brian Daly, and Investigator William Mackay.

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