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Feds Sue Bankers Over Fall in Bonds

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Federal regulators accused J.P. Morgan Chase & Co. and Royal Bank of Scotland Group PLC of duping five large credit unions into buying more than \$3 billion in mortgage bonds that were "destined to perform poorly," and that quickly sank the credit unions.

The two civil lawsuits filed Monday in U.S. District Court in Kansas City, Kan., by the National Credit Union Administration are the most aggressive move yet by U.S. regulators to recover losses from Wall Street firms for alleged wrongdoing before and during the financial crisis.

Many of the nation's 7,000 credit unions, which play a critical role in community lending, have been damaged by the mortgage crisis. More than 40 have failed since the start of 2009, and the survivors are being forced to absorb some of the costs of the failures, forcing some to charge higher interest rates on loans and to pay less on customer deposits.

The collapse of the five large institutions, called wholesale credit unions, "resulted in the worst crisis faced by the credit-union industry in its history," said NCUA Chairman Debbie Matz. "We believe numerous parties within the chain, primary underwriters and intermediaries as well, have responsibility."

J.P. Morgan and RBS declined to comment.

The credit-union failures have saddled the NCUA with roughly \$50 billion in battered bonds that now are worth just a fraction of their original value. Some of those losses are being absorbed by other credit unions in the form of higher payments to the NCUA's insurance fund.

Officials at the NCUA, a federal regulator that supervises the nation's credit unions, expect to file additional lawsuits against as many as eight more banks and securities firms that pooled individual mortgages into securities and sold them to the five credit unions, which failed in 2009 and 2010, according to people familiar with the situation.

The NCUA has issued 986 subpoenas to companies involved in the mortgage machine, including lenders that originate loans, investment banks that sell mortgage-backed securities, mortgage servicers and credit-ratings agencies, a spokesman said.

Proceeds from the lawsuits, which seek more than \$800 million from J.P. Morgan and RBS, would help fund the NCUA's insurance and emergency support funds.

The NCUA has threatened to sue Goldman Sachs Group Inc. and other firms over mortgage-bond sales, according to securities filings and people familiar with the matter. It is currently engaged in settlement discussions with some banks, said an NCUA spokesman. Goldman declined to comment.

The NCUA alleges that the offering documents RBS and J.P. Morgan provided the credit unions contained "untrue statements of material fact or omitted to state material facts" in violation of state and federal securities laws, according to the complaints. The sales pitches caused credit-union officials to underestimate the riskiness of the bonds they purchased, according to the lawsuits.

Federal regulators have come under pressure from lawmakers and the public to take a tougher stand against the executives and companies involved in the mortgage market's decline, which led to the credit crisis and a recession.

The Federal Deposit Insurance Corp. has a team of employees reviewing potential securities claims related to mortgage-backed bonds and other securities purchased by failed banks, an FDIC spokesman said. The Federal Housing Finance Agency, the federal regulator overseeing Fannie Mae and Freddie Mac, last summer issued 64 subpoenas to issuers of mortgage securities, bank servicing companies and other entities.

Several state attorneys general, the U.S. Justice Department, the Securities and Exchange Commission and the Manhattan District Attorney are investigating companies and banks involved in the mortgage market at varying stages in the securitization process. Prosecutors have brought some cases, but have found that voluminous risk disclosures in securities-offering documents have made it challenging to bring cases, some prosecutors have said.

The NCUA is expected to file more lawsuits against Wall Street firms in coming weeks.

The lawsuit against RBS involves roughly \$565 million in claims for bonds sold to U.S. Central Corporate Credit Union, a failed Lenexa, Kan., institution that had been in operation since 1974.

The J.P. Morgan lawsuit involves roughly \$278 million in claims for bonds sold to U.S. Central as well as to four other failed credit unions: Members United Corporate Credit Union, Southwest Corporate Credit Union, Constitution Corporate Credit Union and Western Corporate Credit Union, also known as WesCorp.

Both lawsuits allege that the originators of the underlying mortgages "systematically disregarded the underwriting guidelines stated in the offering documents," resulting in securities that "were destined from inception to perform poorly." As of last month, nearly half of the mortgage loans underlying the securities were delinquent, in bankruptcy or tied up in foreclosure, according to the lawsuits.

Federal regulators accused J.P. Morgan Chase and Royal Bank of Scotland Group of duping five large credit unions into buying more than \$3 billion in mortgage bonds that were "destined to perform poorly," Liz Rappaport reports. (Photo: Reuters.)

Corporate credit unions don't take deposits directly from the public. They provide financing, check clearing and other tasks for credit unions that lend money and take deposits from individuals.

In November 2006, U.S. Central purchased \$120.8 million of mortgage-backed bonds from Royal Bank of Scotland, according to the lawsuit. At the time, the bonds had investment-grade ratings of double-A or higher.

Within one month of issuance, the bonds had lost \$206,255 of their value due to borrowers failing to make payments on their loans, according to the lawsuit. The losses ballooned to \$1.3 million in the second month, \$16 million after three months, \$26 million after six months and \$74.5 million after nine months. After a year, the bonds had lost \$105.9 million—far exceeding the \$11.6 million of "expected losses" that were calculated using ratings-firm methodologies, according to the lawsuit.

As of May 2007, the credit union had sunk about \$16 billion, or 34% of its investments, into risky mortgage bonds, according to the NCUA inspector general.

In March 2009, the regulator took the credit union under conservatorship. Last September, NCUA decided to liquidate U.S. Central.