



# SIGTARP

OFFICE OF THE SPECIAL INSPECTOR GENERAL  
FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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## MORGAN STANLEY AGREES TO \$2.6 BILLION PENALTY IN CONNECTION WITH SALE OF RESIDENTIAL MORTGAGE BACKED SECURITIES

### *SIGTARP Contributes to Investigative Efforts*

WASHINGTON, DC – The Justice Department announced yesterday that Morgan Stanley will pay a \$2.6 billion penalty to resolve claims related to Morgan Stanley’s marketing, sale and issuance of residential mortgage-backed securities (RMBS). This settlement constitutes the largest component of the set of resolutions with Morgan Stanley entered by members of the RMBS Working Group, which have totaled approximately \$5 billion. As part of the agreement, Morgan Stanley acknowledged in writing that it failed to disclose critical information to prospective investors about the quality of the mortgage loans underlying its RMBS, and about its due diligence practices. Investors, including federally insured financial institutions, suffered billions of dollars in losses from investing in RMBS issued by Morgan Stanley in 2006 and 2007.

“Morgan Stanley received \$10 billion from taxpayers in TARP bailout funds knowing they had misled investors and their toxic subprime residential mortgage backed securities (RMBS) caused billions of dollars in losses – this type of abuse in the RMBS market contributed to the financial crisis,” said Christy Goldsmith Romero, Special Inspector General for the Troubled Asset Relief Program (SIGTARP). SIGTARP thanks its partners for their work in this case and will continue to seek justice for bailout-related frauds.”

“[The] settlement holds Morgan Stanley appropriately accountable for misleading investors about the subprime mortgage loans underlying the securities it sold,” said Acting Associate Attorney General Stuart F. Delery. “The Department of Justice will not tolerate those who seek financial gain through deceptive or unfair means, and we will take appropriately aggressive action against financial institutions that knowingly engage in improper investment practices.”

An RMBS is a type of security comprised of a pool of mortgage loans created by banks and other financial institutions. The expected performance and price of an RMBS is determined by a number of factors, including the characteristics of the borrowers and the value of the properties underlying the RMBS. Morgan Stanley was one of the institutions that issued RMBS during the period leading up to the economic crisis in 2007 and 2008.

As acknowledged by Morgan Stanley in a detailed statement of facts that is a part of this agreement (and is quoted below), the company made representations to prospective investors about the

characteristics of the subprime mortgage loans underlying its RMBS – representations with which it did not comply:

- In particular, Morgan Stanley told investors that it did not securitize underwater loans (loans that exceeded the value of the property). However, Morgan Stanley did not disclose to investors that in April 2006 it had expanded its “risk tolerance” in evaluating loans in order to purchase and securitize “everything possible.” As Morgan Stanley’s manager of valuation due diligence told an employee in 2006, “please do not mention the ‘slightly higher risk tolerance’ in these communications. We are running under the radar and do not want to document these types of things.” As a result, Morgan Stanley ignored information – including broker’s price opinions (BPOs), which are estimates of a property’s value from an independent real estate broker – indicating that thousands of securitized loans were underwater, with combined-loan-to-value ratios over 100 percent. From January 2006 through mid-2007, Morgan Stanley acknowledged that “Morgan Stanley securitized nearly 9,000 loans with BPO values resulting in [combined loan to value] ratios over 100 percent.”

- Morgan Stanley also told investors that it did not securitize loans that failed to meet originators’ guidelines unless those loans had compensating factors. Morgan Stanley’s offering documents “represented that ‘[the mortgage loans originated or acquired by [the originator] were done so in accordance with the underwriting guidelines established by [the originator]’ but that ‘on a case-by-case-basis, exceptions to the [underwriting guidelines] are made where compensating factors exist.’” Morgan Stanley has now acknowledged, however, that “Morgan Stanley did not disclose to securitization investors that employees of Morgan Stanley received information that, in certain instances, loans that did not comply with underwriting guidelines and lacked adequate compensating factors . . . were included in the RMBS sold and marketed to investors.” So, in fact, “Morgan Stanley . . . securitized certain loans that neither comported with the originators’ underwriting guidelines nor had adequate compensating factors.”

- Likewise, “Morgan Stanley also prepared presentation materials . . . that it used in discussions with potential investors that described the due diligence process for reviewing pools of loans prior to securitization,” but “certain of Morgan Stanley’s actual due diligence practices did not conform to the description of the process set forth” in those materials.

- For example, Morgan Stanley obtained BPOs for a percentage of loans in a pool. Morgan Stanley stated in these presentation materials that it excluded any loan with a BPO value exhibiting an “unacceptable negative variance from the original appraisal,” when in fact “Morgan Stanley never rejected a loan based solely on the BPO results.”

- Through these undisclosed practices, Morgan Stanley increased the percentage of mortgage loans it purchased for its RMBS, notwithstanding its awareness about “deteriorating appraisal quality” and “sloppy underwriting” by the sellers of these loans. The bank has now acknowledged that “Morgan Stanley was aware of problematic lending practices of the subprime originators from which it purchased mortgage loans.” However, it “did not increase its credit-and-compliance due diligence samples, in part, because it did not want to harm its relationship with its largest subprime originators.” Indeed, Morgan Stanley’s manager of credit-and-compliance due diligence was admonished to “stop fighting and begin recognizing the point that we need monthly volume from our biggest trading partners and that . . . the client [an originator] does not have to sell to Morgan Stanley.”

The \$2.6 billion civil monetary penalty resolves claims under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). FIRREA authorizes the federal government to impose civil penalties against financial institutions that violate various predicate offenses, including wire and mail fraud. The settlement expressly preserves the government's ability to bring criminal charges against Morgan Stanley, and likewise does not release any individuals from potential criminal or civil liability. In addition, as part of the settlement, Morgan Stanley promised to cooperate fully with any ongoing investigations related to the conduct covered by the agreement.

In conjunction with yesterday's announcement of the federal government's settlement with Morgan Stanley, the states of New York and Illinois – also members of the RMBS Working Group – have announced settlements with Morgan Stanley for \$550 million and \$22.5 million, respectively, arising from its sale of RMBS. Among other resolutions, Morgan Stanley previously paid \$225 million to resolve claims brought by the National Credit Union Administration arising from losses related to corporate credit unions' purchases of RMBS; \$1.25 billion to resolve claims by Federal Housing Finance Agency (FHFA) for Morgan Stanley's alleged violations of federal and state securities laws and common law fraud in connection with RMBS purchased by Fannie Mae and Freddie Mac; and \$86.95 million to resolve federal and state securities laws claims brought by the Federal Deposit Insurance Corporation as receiver on behalf of failed financial institutions. Morgan Stanley also previously entered into a consent decree with the U.S. Securities and Exchange Commission (SEC) to pay \$275 million to resolve certain RMBS claims. With yesterday's announcement, Morgan Stanley will have paid nearly \$5 billion to members of the RMBS Working Group in connection with its sale of RMBS.

These settlements are part of the ongoing efforts of President Obama's Financial Fraud Enforcement Task Force's RMBS Working Group, which has recovered billions of dollars arising from misconduct related to the financial crisis. The RMBS Working Group is a federal and state law enforcement effort focused on investigating fraud and abuse in the RMBS market that helped lead to the 2008 financial crisis. The RMBS Working Group brings together attorneys, investigators, analysts and staff from multiple state and federal agencies, including the Department of Justice, U.S. Attorneys' Offices, the FBI, the SEC, the Department of Housing and Urban Development (HUD), HUD's Office of Inspector General, the FHFA Office of Inspector General (OIG), the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), the Federal Reserve Board's OIG, the Recovery Accountability and Transparency Board, the Financial Crimes Enforcement Network and multiple state Attorneys General offices around the country.

Yesterday's settlement was the result of a coordinated effort between the Department of Justice Civil Division's Commercial Litigation Branch and the U.S. Attorney's Office of the Northern District of California, with investigative support from the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) and FHFA-OIG.

Learn more about the RMBS Working Group and the Financial Fraud Enforcement Task Force at: [www.stopfraud.gov](http://www.stopfraud.gov)

#### About SIGTARP

The Office of the Special Inspector General for the Troubled Asset Relief Program was created as an independent law enforcement agency to investigate fraud, waste, and abuse related to the TARP bailout. To date, SIGTARP investigations have resulted in the recovery of over \$2.57 billion to the Government and over 140 defendants sentenced to prison.

To report a suspected crime related to TARP, call **SIGTARP's Crime Tip Hotline**: 1-877-SIG-2009 (1-877-744-2009).

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