



# Department of Justice

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

WASHINGTON – The Justice Department today announced 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.

“Today’s 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.”

“Those who contributed to the financial crisis of 2008 cannot evade responsibility for their misconduct,” said Principal Deputy Assistant Attorney General Benjamin C. Mizer, head of the Justice Department’s Civil Division. “This resolution demonstrates once again that the Financial Institutions Reform, Recovery and Enforcement Act is a powerful weapon for combatting financial fraud and that the department will not hesitate to use it to hold accountable those who violate the law.”

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.”

“In today’s agreement, Morgan Stanley acknowledges it sold billions of dollars in subprime RMBS certificates in 2006 and 2007 while making false promises about the mortgage loans backing those certificates,” said Acting U.S. Attorney Brian J. Stretch of the Northern District of California. “Morgan Stanley touted the quality of the lenders with which it did business and the due diligence process it used to screen out bad loans. All the while, Morgan Stanley knew that in reality, many of the loans backing its securities were toxic. Abuses in the mortgage-backed securities industry such as these helped bring about the most devastating financial crisis in our lifetime. Our office is committed to dedicating the resources necessary to hold those who engage in such reckless actions responsible for their conduct.”

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 today’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 today’s announcement, Morgan Stanley will have paid nearly \$5 billion to members of the RMBS Working Group in connection with its sale of RMBS.

Today’s settlement is 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, 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. The RMBS Working Group is led by Director Joshua Wilkenfeld and five co-chairs: Principal Deputy Assistant Attorney General Benjamin C. Mizer of the Justice Department's Civil Division, Assistant Attorney General Leslie R. Caldwell of the Justice Department's Criminal Division, Director Andrew Ceresney of the SEC's Division of Enforcement, U.S. Attorney John Walsh of the District of Colorado and New York Attorney General Eric Schneiderman.

"The securitization of defective mortgages and the billions of dollars that were lost as a result caused such a hardship to our economy, the housing industry and our nation as a whole that we are still feeling the effects years after," said Deputy Inspector General for Investigations Rene Febles of FHFA-OIG. "Morgan Stanley is responsible for their role, which caused enormous losses to investors. This settlement is one step in recovering from those losses. We are proud to work with the RMBS Working Group and the U.S. Department of Justice on this and all RMBS matters."

The settlement was the result of a coordinated effort between the Civil Division's Commercial Litigation Branch and the U.S. Attorney's Office of the Northern District of California, with investigative support from FHFA-OIG.

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

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