10 Years After the Financial Crisis: Where Do Shareholder Rights Stand?

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A Recap of the Financial Crisis
Rewind 10 Years

- The worst U.S. economic disaster since the Great Depression
- Stock market drop wiped out almost $8 trillion in value between 2007-2009
- Unemployment climbed to 10% in October 2009
- Americans lost $9.8 trillion in wealth as their home values declined and retirement accounts were depleted
- Great recession led to a loss of more than $2 trillion in global economic growth or a drop of about 4%
Ground Zero for the Great Recession: The Subprime Housing Market

- **Subprime Mortgages**: Mortgages given to people with a bad credit history or no credit history

- In early 2000’s banks and other mortgage lenders made increasingly **riskier loans**. Why?
  - Bonuses tied to mortgages generated
  - Home prices continued rising
  - Federal policies facilitating home ownership for every American
    (Required Fannie Mae and Freddie Mac to meet quotas of buying low/moderate income mortgages)
  - Wall St.’s voracious appetite for mortgages to generate commissions from sale of Residential Mortgage Backed Securities (“RMBS”)
Ground Zero for the Great Recession: The Subprime Housing Market

• To offload risk banks sold mortgages to underwriters who created RMBS they sold to investors (like a bond paying interest secured by homes as collateral)
  – The Bonds “riskiness” depended on homeowners’ ability to pay off loans on the mortgages held as collateral
  – To mitigate risk Wall St. underwriters entered into Credit Default Swaps (i.e. insurance to pay investors if underlying mortgages went bad)
  – AIG was primary insurer
Ground Zero for the Great Recession: The Subprime Housing Market

• How did credit risks obtain mortgages?
  • No money or little money down loans
  • Adjustable rate mortgages with low early interest rates
  • Fraud by mortgage brokers re: applicant’s credit-worthiness
What Went Wrong?

- As interest rates on adjustable mortgages increased or homeowners otherwise could not make mortgage payments, they defaulted on their mortgages resulting in foreclosures.
- As housing market dipped and rate of defaults and foreclosures increased, more homes for sale caused home values to drop.
- As home prices dropped and homes sat in foreclosure, collateral securing mortgages held in RMBS was worth less and fewer homeowner payments caused short-falls in principal and interest payments harming RMBS investors, insurers and underwriters.
- As crisis accelerates, layoffs increased, resulting in more homeowners (now unemployed) defaulting on mortgages, causing losses that RMBS insurers and Wall St. banks could not pay off which led to problem spiraling out of control.

- **2007:** Default Rate in US subprime mortgages increases
- **4/2007:** New Century Financial Corp., a leading subprime mortgage lender, files for Ch. 11 bankruptcy protection
- **6/2007:** S&P and Moody’s downgrade over 100 bonds backed by second-lien subprime mortgages
- **8/6/07:** American Home Mortgage Investment, which specializes in adjustable-rate mortgages, files for bankruptcy protection
Jan. 2008 – July 2008: Crisis in the Credit Markets

• 1/2008: Bank of America buys Countrywide for $4 billion in stock
• 2/2008: Northern Rock, the U.K.’s 5th largest mortgage lender, is taken over by the State
• 3/2008: Bear Stearns fails; JPMorgan Chase buys Bear with $30 billion financing from the Federal Reserve
• 7/2008: IndyMac Federal Bank becomes largest federal thrift to fail; seized by Federal Regulators
Sept. 2008: Crisis Accelerates

- **9/7:** Fannie Mae and Freddie Mac taken over by US government
- **9/12:** Lehman Brothers files for bankruptcy
- **9/15:** Bank of America buys Merrill Lynch
- **9/16:** $85 billion bailout of AIG that gives U.S. Government a 79.9% stake in the company
- **9/17:** The SEC announces a temporary emergency ban on short-selling in the stocks of all companies in the financial sector
- **9/19:** Because U.S. investors withdrew about $300 billion from prime money market mutual funds, the U.S. Treasury and Federal Reserve essentially guaranteed all the money market funds in the U.S. to calm investor panic
Sept. 2008: Crisis Accelerates

• 9/21: Goldman Sachs and Morgan Stanley, the last two independent investment banks, agree to become bank holding companies subject to greater regulation by the Federal Reserve
  • Consequently, during the financial crisis the 5 largest investment banks regulated by the SEC – Bear Stearns, Merrill Lynch, Morgan Stanley, Lehman Brothers and Goldman Sachs – either went bankrupt, became banks or were acquired by a bank

• 9/25: Washington Mutual fails and its branches are sold to JPMorgan Chase for $1.9 billion
Sept. – Oct. 2008: Crisis Accelerates

- **9/29:** Congress rejects a $700 billion Wall St. financial rescue package known as the Troubled Asset Relief Program (TARP)
  - The DJIA immediately drops 778 points, the single-largest point drop ever

- **10/3:**
  - Wells Fargo buys Wachovia for $14.8 billion
  - Congress passes, and Pres. Bush signs, the Emergency Economic Stabilization Act of 2008 which establishes the revised $700 billion TARP Program

- **10/24:** PNC Financial Services Group, Inc. purchases National City Corporation, creating the 5th largest U.S. Bank
Responses to the Financial Crisis
Immediate Governmental Responses to the Financial Crisis

- **11/18/08**: Ford, GM and Chrysler executives testify before Congress requesting federal loans from TARP
- **11/23/08**: The Treasury Dept., Federal Reserve and the FDIC agree to rescue **Citigroup** with a series of measures
- **12/3/08**: SEC approves measures to increase transparency and accountability at credit rating agencies (e.g. S&P, Moody’s) and ensure more meaningful ratings and greater disclosure to investors
- **12/10/08**: News of the Bernie Madoff Ponzi scheme breaks
Immediate Governmental Responses to the Financial Crisis

• **12/19/08:** The U.S. Treasury authorizes loans to GM ($13.4 billion) and Chrysler ($4 billion) from TARP

• **1/16/09:** As President Obama begins Presidency U.S. Treasury invests **$20 billion** in Bank of America from TARP for preferred stock

• **6/25/09:** AIG agrees to give a $25 billion equity stake to Federal Reserve to reduce debt it borrowed
The Economy Begins to Stabilize

• 10/09: DJIA closes above 10,000 for first time since 10/03/08
• 12/09: Bank of America, Citigroup and Wells Fargo separately announce they will repay or repurchase securities issued from TARP collectively paying back $90 billion to U.S. Government

• In total, U.S. Gov’t. TARP program injected $412 billion into banks, carmakers, etc. By end of 2017 Gov’t. recouped $424 billion, $12 billion profit. Not done yet.
• Fannie Mae, loaned $119.8 billion, has returned $167.3 billion to U.S. Treasury (Gov’t. made over $47 billion)
• Freddie Mac, loaned $71.6 billion, has returned $112.4 billion in profits (Gov’t. made nearly $42 billion)
Criminal Prosecutions

Criminal Prosecutions

• U.S. prosecutors convicted 324 mortgage lenders, loan officers, real estate brokers, developers and others at the front end of the crisis

• Banks paid $150 billion in fines and consumer relief, but no high level convictions
  • In comparison, Iceland prosecuted the CEOs of 3 large banks and 23 other bankers

Civil Litigation

- Over 200 subprime and credit crisis securities litigations filed by private investors and U.S. agencies
- Between 2007 and July 2017, $133.2 billion in settlements
  - ~$87 billion DOJ and gov’t agency
  - ~$21 billion private litigation

Financial Crisis Securities Settlements Obtained By Public Pension Funds

- Bank of America – $2.4 billion
  - Ohio State Teachers Ret. Sys.; Ohio PERS; Texas Teachers Ret. Sys.
- Citigroup Bonds – $730 million
  - Arkansas Teacher Retirement Systems and Louisiana Sheriff’s Pension and Relief Fund
- Citigroup Securities – $590 million
  - Public Employees’ Retirement Association of Colorado
- Wachovia – $627 million
  - City of Livonia Employee’s Retirement System, Hawaii Sheet Metal Workers Pension Fund

Source: Credit Crisis Litigation Update: It is Settlement Time, NERA (Oct. 2013)
Financial Crisis Securities Settlements Obtained By Public Pension Funds

• Countrywide – $624 million
  • New York City Employees’ Retirement System, New York City Police Pension Fund, New York City Fire Department Pension Fund, New York City Board of Education Retirement System, and Teachers’ Retirement System of the City of New York

• Merrill Lynch – $475 million
  • Ohio State Teachers Retirement System

Source: Credit Crisis Litigation Update: It is Settlement Time, NERA (Oct. 2013).
2010: Dodd-Frank Wall Street Reform And Consumer Protection Act

- Volcker Rule
  - Commercial banks can’t use customer deposits for speculative/proprietary trading
- Too Big to Fail and Living Wills
  - Ability to wind down large financial institutions instead of bankruptcy
  - Large banks must have living wills – detailed plan to manage their own failure without a taxpayer bailout

2010: Dodd-Frank Wall Street Reform and Consumer Protection Act
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• Bank capital requirements:
  • Increased capital and liquidity requirements for banks
  • Stress-testing regimens enable banks and regulators to better manage risk

• Consumer Finance Protection Bureau
• CEOs/CFOs required to sign SEC filings
Where Are We Now?
What Has Been the Long-Term Impact of the Financial Crisis on the Economy? The Good News

- The U.S. economy has largely recovered:
  - Stock market set a record for longest-running increase in history
  - Unemployment is low at 3.9% in July
  - Most homeowners have recovered value they lost
What Has Been the Long-Term Impact of the Financial Crisis on the Economy? The Bad News

• The recovery has not impacted all Americans equally:
  • Many workers have struggled to land jobs paying pre-recession wages
  • With time out of work plus lower current pay, the average American lost $70,000 in lifetime income
  • At end of 2017, 4.4 million homeowners were underwater on their mortgage (home worth less than they owed)
  • Now harder for low-income, low-credit score borrowers to get mortgages
However, Wall St. has Recovered Nicely

- By 2010, just two years post-crisis, compensation at publicly traded Wall St. firms hit a new record
- Record average bonus paid by Wall St. – $191,360 in 2006
  - 2017 average Wall St. bonus – $184,220
- The 10 biggest U.S. banks posted annual profits of more than $62 billion
2018: Economic Growth, Regulatory Relief, And Consumer Protection Act

• Raises threshold for closer Fed oversight from $50 billion to $250 billion in assets
  • No living will
  • No Federal Reserve stress test
• Exempts lenders with less than $10 billion in assets from Volcker Rule
• Loosens oversight on “systematically important” non-banks
• Leaves 10 big banks subject to stricter oversight
Recent Stormwarnings of an Assault on Shareholder Rights

The Fairness in Class Action Litigation Act of 2017

- Proposed legislation, which passed the House in March 2017 and is currently pending in the Senate, seeks to favor defendants in class actions in federal court

- Legislation would:
  - Provide automatic stay of discovery pending motion practice
  - Limit attorneys’ fees in certain respects
  - Allow automatic right of all parties to interlocutory appeal class certification decisions
  - Force disclosure of third-party funding

- Effect will be to drag out every litigation
Recent Stormwarnings of an Assault on Shareholder Rights

SEC Commissioner’s Willingness to Kill Class Actions

- SEC Commissioner Michael S. Piwowar said in a speech to the conservative Heritage Foundation in July 2017 that the SEC is open to the idea of allowing companies contemplating IPOs to include mandatory shareholder arbitration provisions in corporate charters.

- This would mandate that any dispute by a shareholder with a corporation be arbitrated.
  - no litigation in a court of law and no right to a jury
  - no class action litigation, only individual actions
Potential Causes of the Next Financial Crisis

• **Debt Bubble**
  - Another housing bubble
    • Post financial crisis housing policies did not significantly change. Fannie/Freddie continue to buy mortgages with 3% down payments as housing prices go up
  - Auto loan securitization bubble
    • More than $70 billion in auto-backed securities (similar to RMBS) sold in 2017
    • Auto loan delinquencies are rising (4.3% were delinquent by 90 days or more as of 3/18)
  - Student loans (not dischargeable in bankruptcy)

• **ETF crash** – liquidity crisis?

• **Cybersecurity**
  • Cyberattacks can illicitly move vast sums of money from one bank to another