Internet Appendix For "Do Labor Markets Discipline? Evidence from RMBS Bankers"

Appendix C. Excerpts from DOJ Settlement Statements of Facts

All excerpts are exact quotes from Statements of Facts in DOJ settlements with Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, and Morgan Stanley.

A) Statements indicating that acknowledged activities were widespread, rampant, or egregious

Bank of America (including Countrywide and Merrill Lynch):

- At the time Bank of America made these representations, its internal reporting showed that "wholesale" mortgages—that is, loans originated through third-party mortgage brokers—had decreased in performance and were experiencing an increase in underwriting exceptions.[1]

- Merrill Lynch's subprime due diligence manager received the vendors' reports and the results of the due diligence reviews throughout the whole loan acquisition process. The vendors' reports were also available to others in Merrill Lynch's RMBS business, including those on the trading desk and in the securitization group. These reports showed that some due diligence samples had an EV3 rate as high as 50% of the loans sampled.[2]

- In addition, due diligence personnel and, in certain instances, traders on Merrill Lynch's Whole Loan Trading Desk, reevaluated certain loans graded EV3 by the vendor and, in certain circumstances, overruled the vendor's grade and "waived" particular loans into the purchased pool.[3]

- Merrill Lynch accepted certain loans for purchase and securitization where the reported appraised value at the time of origination was as much as 10 to 15% higher than the valuation firm's estimated value of the property. In addition, some of the RMBS issued by Merrill Lynch potentially contained loans with an LTV in excess of 100%, based on valuations obtained from AVMs.[4]

- Similarly, in an email dated June 7, 2007, CFC's Chief Investment Officer wrote to CFC's President, "[W]hen credit was easily salable, SLD was a way to take advantage of the 'salability' and do loans outside guidelines and not let our views of risk get in the way."[5]

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[1] United States Department of Justice, Settlement Agreement between Bank of America (including Countrywide and Merrill Lynch) and the United States, "Annex 1 - Statement of Facts", August 21, 2014, p. 1. (https://www.justice.gov/iso/opa/resources/4312014829141220799708.pdf).
[2] *Id.* at p. 3.
[3] *Ibid.*
[4] *Id.* at pp. 5-6.
[5] *Id.* at p. 9.

- On July 28, 2005, a Countrywide executive sent an email informing the SLD that it could begin to expand the programs for which it could approve "exception" loans to programs other than the 30 year fixed and 5/1 ARM loan products. He wrote:

  > [T]o the widest extent possible, we are going to start allowing exceptions on all requests, regardless of program, for all loans less than $3 million, effective immediately.[6]

Citigroup:

- Citigroup's due diligence vendors graded a number of sampled loans, both from loan pools to be securitized and from loans funded through "warehouse" lines of credit, as EV3, including loans that the vendors found did not comply with applicable laws and regulations due to missing documentation. In certain instances, Citigroup's due diligence personnel reevaluated certain of the vendors' loan grades and instructed its due diligence vendor to change some of those grades from an EV3 to an EV2 or EV1.[7]

- In certain instances, Citigroup securitized loans that its vendors had reported exceeded Citigroup's valuation tolerances or where the vendor's valuation determination exceeded the reported or appraised value.[8]

Credit Suisse:

- Credit Suisse told investors and ratings agencies that it used a proprietary risk analysis model in its sampling process to identify high-risk loans in Bulk pools. The purpose of this model was to flag these high-risk loans for inclusion in due diligence samples. In many instances, however, Credit Suisse excluded loans that its own model had flagged as high risk from its samples. Through this practice, Credit Suisse approved some of these flagged loans without any credit or compliance due diligence review. Credit Suisse did not disclose this practice to investors.[9]

- Despite these results, Credit Suisse did not expand its credit and compliance reviews to the rest of the loan pool as a whole, or even to the remaining loans that its risk analysis model had flagged. Instead, it approved the unsampled loans without any credit or compliance due diligence, closed on its purchase of this pool, and securitized these loans into various RMBS it then sold to investors.[10]

Deutsche Bank:

- The same month, the Diligence Supervisor admitted that Deutsche Bank, among other banks, "tolerate[d] misrepresentation" from mortgage loan originators with "misdirected lending practices." Those originators, for example, "marked out" borrowers' pay stubs in

[6] *Id.* at p. 10.
[7] United States Department of Justice, Settlement Agreement between Citigroup and the United States, "Statement of Facts", July 14, 2014, p. 5. (https://www.justice.gov/iso/opa/resources/558201471413645397758.pdf).
[8] *Ibid.*
[9] United States Department of Justice, Settlement Agreement between Credit Suisse and the United States, "Annex 1 - Statement of Facts", January 18, 2017, p. 7. (https://www.justice.gov/opa/press-release/file/928496/download).
[10] *Id.* at pp. 9-10.

order to state, often fraudulently, that the borrowers had higher incomes: [T]he marked out paystub is just an example of how misdirected lending practices have become; we tolerate misrepresentation. What goes around will eventually come around; when performance (default) begins affecting profits and/or the investors who purchase the securities, only then will Wall St. take notice. For now, the buying continues.[11]

- In 2006 and 2007, Deutsche Bank securitized thousands of loans that Clayton graded EV3s and Deutsche Bank waived to EV2Ws. (*See* Appendix A.) Indeed, the Diligence Supervisor admitted that Deutsche Bank waived many EV3s for large originators because, for instance, "Fremont is one of our special Sellers and we want to provide addl. Flexibility."[12]

- Indeed, in 2006 and 2007, Deutsche Bank's Diligence Supervisor believed that "most (if not all) Stated Wage Earner loans have inflated incomes," and the Subprime MD commented that "borrower or broker fraud is rampant on these" types of loans. Nevertheless, Deutsche Bank did not implement a practice of reviewing all stated income loans in pools of loans that it purchased.[13]

Goldman Sachs:

- According to a "trending report" prepared by one of Goldman's due diligence vendors (later described by the vendor as a "beta" or test report), of the 111,999 loans that vendor reviewed for Goldman from the first quarter 2006 through the second quarter of 2007, 25,607 of them, or 23 percent, were graded as EV3s. According to the report, Goldman directed the vendor to change 7,467 of these EV3 loans—29 percent—to EV2.[14]

- Goldman also received information about risks in the mortgage market from Senderra, a tiny regional originator in which Goldman had previously acquired a 12.5 percent stake. On December 10, 2006, the Chief Executive Officer of Senderra sent an email to, among others, a Goldman mortgage department manager, with observations regarding the "dramatic shifts and disruption in the industry." Senderra's CEO noted that credit quality had become a "major crisis" across the subprime market, and that "[i]nvestors ha[d] taken a strong stand" in response to "unprecedented defaults and fraud in the market" and were "pushing loans back to originators/lenders in record numbers." The Senderra executive noted that some originators had announced publicly that they were shutting down due to increasing EPD claims. The Senderra executive also reported seeing increasing numbers of loans in the market with "inflated appraisals, inflated income and occupancy fraud."[15]

JP Morgan (including Bear Stearns and Washington Mutual):

- JPMorgan directed that a number of the uncured Event 3 loans be "waived" into the pools facilitating the purchase of loan pools, which then went into JPMorgan inventory for

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[11] United States Department of Justice, Settlement Agreement between Deutsche Bank and the United States, "Annex 1 - Statement of Facts", January 17, 2017, p. 11. (https://www.justice.gov/opa/press-release/file/927271/download).
[12] *Id.* at p. 14.
[13] *Id.* at p. 20.
[14] United States Department of Justice, Settlement Agreement between Goldman Sachs and the United States, "Annex 1 - Statement of Facts", April 11, 2016, p. 5. (https://www.justice.gov/opa/file/839901/download).
[15] *Id.* at p. 12.

securitization. In addition to waiving in some of the Event 3 loans on a case-by-case basis, some JPMorgan due diligence managers also ordered "bulk" waivers by directing vendors to override certain exceptions the JPMorgan due diligence managers deemed acceptable across all Event 3 loans with the same exceptions in a pool, without analyzing these loans on a case-by-case basis. JPMorgan due diligence managers sometimes directed these bulk waivers shortly before closing the purchase of a pool.[16]

- In one instance, JPMorgan's due diligence revealed that several pools from a single third-party originator contained numerous stated income loans (i.e., loans originated without written proof of the borrower's income) where the vendor had concluded that borrowers had overstated their incomes. Initially, due diligence employees and at least two JPMorgan managers decided that these pools should be reviewed in their entirety, and all unreasonable stated income loans eliminated before the pools were purchased. After the originator of the loan pools objected, JPMorgan Managing Directors in due diligence, trading, and sales met with representatives of the originator to discuss the loans, then agreed to purchase two loan pools without reviewing those loan pools in their entirety as JPMorgan due diligence employees and managers had previously decided; waived a number of the stated income loans into the pools; purchased the pools; and subsequently securitized hundreds of millions of dollars of loans from those pools into one security.[17]

- In certain circumstances, Bear Stearns due diligence managers or other employees determined after their review of the loans that, notwithstanding a vendor's identification of exceptions to specified underwriting guidelines, Bear Stearns would purchase loans where there was a variance from the guidelines that the managers or other employees deemed acceptable. In addition, Bear Stearns completed bulk purchases of Alt-A loan pools even though the rate of loans with exceptions in the due diligence samples indicated that the un-sampled portion of a pool likely contained additional loans with exceptions.[18]

- Prior to WaMu's failure and closure by the Office of Thrift Supervision ("OTS") in 2008, internal WaMu reviews indicated specific instances of weaknesses in WaMu's loan origination and underwriting practices, including, at times, non-compliance with underwriting standards; the reviews also revealed instances of borrower fraud and misrepresentations by others involved in the loan origination process with respect to the information provided for loan qualification purposes.[19]

Morgan Stanley:

- In another instance from July 2006, this additional review resulted in clearing dozens of loans for purchase after less than one minute per review per loan file. Through this

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[16] United States Department of Justice, Settlement Agreement between JPMorgan (including Bear Stearns and Washington Mutual) and the United States, "Annex 1 - Statement of Facts", November 19, 2013, pp. 4-5. (https://www.justice.gov/iso/opa/resources/94320131119151031990622.pdf).
[17] *Id.* at pp. 5-6.
[18] *Id.* at p. 10.
[19] *Ibid.*

additional review, Morgan Stanley accepted loans for purchase when it had information indicating loans had CLTV ratios in excess of 100 percent.[20]

- In 18 MSAC trusts with New Century loans, Morgan Stanley securitized nearly 5,000 loans with BPO values that were at least 15 percent lower than the appraisal values at loan origination or the purchase prices. In these same trusts, Morgan Stanley securitized nearly 9,000 loans with BPO values resulting in CLTV values over 100 percent and approximately 1,000 loans where the property value estimates that Morgan Stanley calculated during the mitigation process resulted in CLTV ratios over 100 percent.[21]

- Morgan Stanley reviewed all loans Clayton graded as EV3 and made a final determination regarding the loan's grade. After reviewing all loans that Clayton graded as EV3 loans, Morgan Stanley assigned its own grade of EV2 to a majority of these loans, which were subsequently purchased and securitized.[22]

[20] United States Department of Justice, Settlement Agreement between Morgan Stanley and the United States, "Annex 1 - Statement of Facts", February 11, 2016, p. 10. (https://www.justice.gov/opa/file/823671/download).
[21] *Ibid.*
[22] *Id.* at p. 12.

B) Statements indicating that acknowledged activities were widely known at the bank

Bank of America (including Countrywide and Merrill Lynch):

- In an internal email that discussed due diligence on one particular pool of loans, a consultant in Merrill Lynch's due diligence department wrote: "[h]ow much time do you want me to spend looking at these [loans] if [the co-head of Merrill Lynch's RMBS business] is going to keep them regardless of issues? . . . Makes you wonder why we have due diligence performed other than making sure the loan closed."[23]

- Through the due diligence process in 2005 and 2006, Merrill Lynch also learned that certain originators were loosening their underwriting guidelines, resulting in Merrill Lynch's identifying, for example, an increasing number of loans with unreasonable stated incomes. Merrill Lynch's due diligence manager brought this to the attention of Merrill Lynch's head of whole loan trading in a memorandum written in November 2005. Merrill Lynch, however, continued to acquire and securitize loans from some of these originators without substantially altering its disclosures to investors. A year later, in December 2006, Merrill Lynch's due diligence manager again brought the loosening of originator guidelines to the attention of the head of whole loan trading in another memorandum. Merrill Lynch still continued to acquire and securitize loans from some of those originators without substantially altering its disclosures to investors.[24]

- As discussed below, from 2005 to 2007, Countrywide originated an increasing number of loans as exceptions to its Loan Program Guides. At the same time, employees of Countrywide received information indicating that there was an increased risk of poor performance for certain mortgage programs and products that were being included in RMBS.[25]

- On August 1, 2005, CFC's Chairman sent an email to CHL's President and head of loan production and CB's President stating:

> I am becoming increasingly concerned about the environment surrounding the borrowers who are utilizing the pay option loan and the price level of real estate in general but particularly relative to condos and specifically condos being purchased by speculators (non owner occupants). I have been in contact with developers who have told me that they are anticipating a collapse in the condo market very shortly simply related to the fact that in Dade County alone 70% of the condos being sold are being purchased by speculators. The situation being reported in Broward County, Las Vegas as well as other so called "hot" areas of the Country.
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> We must therefore re-think what assets [we] should be putting in the bank. For example you should never put a non-owner occupied pay option Arm

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[23] United States Department of Justice, Settlement Agreement between Bank of America (including Countrywide and Merrill Lynch) and the United States, "Annex 1 - Statement of Facts", August 19, 2015, p. 3. (https://www.justice.gov/iso/opa/resources/ 4312014829141220799708.pdf).
[24] *Id.* at p. 5.
[25] *Id.* at p. 6.

> on the balance sheet. I know you have already done this but it is unacceptable. Secondly only 660 fico's and above, owner occupied should be accepted and only on a limited basis. The focus should be on 700 and above (owner occupied) for this product. The simple reason is that when the loan resets in five years there will be enormous payment shock and the borrower is not sufficiently sophisticated to truly understand the consequences then the bank will be dealing with foreclosure in potentially a deflated real estate market. This would be both a financial and reputational catastrophe.

On August 2, 2005, CHL's president responded to this email, writing that this approach had "securitization implications":

> We need to analyze what remains if the bank is only cherry picking and what remains to be securitized/sold is overly concentrated with higher risk loans. The concern and issue gets magnified as we put a bigger percentage of our pay option production into the Bank because the remaining production then increasingly looks like an adversely selected pool.

On August 2, 2005, CFC's Chairman responded to this email:

> I absolutely understand your position however there is a price no matter what we do. The difference being that by placing less attractive loans in the secondary market we will know exactly the economic price we will pay when the sales settle. [26]

- On April 3, 2006, CFC's Chairman sent to CHL's President and head of loan origination an email observing that there was:

> important data that could portend serious problems with [PayOption ARMs]. Since over 70% have opted to make the lower payments it appears that it is just a matter of time that we will be faced with a substantial amount of resets and therefore much higher delinquencies. We must limit [CB's retained investment in] this product to high ficos otherwise we could face both financial and regulatory consequences.[27]

Citigroup:

- In addition, early in the due diligence process, a trader at Citigroup wrote an internal email that indicated that he had reviewed a due diligence report summarizing loans that the due diligence vendor had graded as EV3s and had noted that "a lot" of these rejected loans had unreasonable income and values below the original appraisal, which resulted in combined loan- to-value in excess of 100 percent. The trader stated that he "went thru the Diligence Reports and think that we should start praying… I would not be surprised if half of these loans went down. There are a lot of loans that have unreasonable incomes,

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[26] *Id.* at pp. 11-12.
[27] *Id.* at p. 13.

values below the original appraisals (CLTV would be >100), etc. It's amazing that some of these loans were closed at all."[28]

- As part of that acquisition, Citigroup conducted due diligence on the companies. As part of that due diligence, Citigroup received some of the company's internal audit reports, and distributed them to, among others, a Managing Director who was involved with Citigroup's RMBS securitizations. The internal audit reports showed that the seller had itself found, in the prior year, that it lacked key internal controls over its quality assurance for loan production, and that substantial percentages of the loans failed to adhere to underwriting guidelines, which the seller itself labelled as "high risk."[29]

Credit Suisse:

- In October 2005, Credit Suisse's Head of Credit and Underwriting wrote to two senior Credit Suisse traders and others, "We are selling and securitizing loans with missing docs all the time through the other desks."[30]

- In December 2006, Credit Suisse bid on a Bulk pool of approximately 10,000 loans originated by Countrywide Home Loans ("Countrywide"). Before the bid, the senior Credit Suisse trader bidding on the pool wrote in an email, "Amazing that 8% of the pool is already delinquent after 10 months, when a large part of it is Jumbo A!!!" He stated that the pool was "obviously plugged with the worst of paper." The senior trader then bid to purchase this pool and, when he was informed that Credit Suisse was the winning bidder, wrote in an email, "I'm ecstatic" with this trade.[31]

- The Credit Suisse due diligence manager overseeing this review reported that Credit Suisse's vendor "has found a number of guideline exceptions (fico score exceptions, LTV [loan-to-value] exceptions, Program exceptions)[.] However I am not rejecting for these items." The Co-Head of Credit Suisse's Transaction Management department, wrote to the due diligence manager, "Thanks for working thru this mess. If it helps, it looks like we will make a killing on this trade."[32]

- Credit Suisse employees, including two senior traders, discussed Resource Bank internally in emails, referring to Resource Bank loans as "complete crap" and "[u]tter complete garbage." One of the traders informed the Co-Heads of the Structured Products Group and others that "Resource Bank is the biggest culprit and our worst performer" in terms of delivering high combined loan-to-value (CLTV) loans, which "[are] performing progressively worse each quarter and [] rife with fraud." Despite these concerns, Credit

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[28] United States Department of Justice, Settlement Agreement between Citigroup and the United States, "Statement of Facts", July 14, 2014, p. 8. (https://www.justice.gov/iso/opa/resources/558201471413645397758.pdf).
[29] *Ibid.*
[30] United States Department of Justice, Settlement Agreement between Credit Suisse and the United States, "Annex 1 - Statement of Facts", January 18, 2017, p. 5. (https://www.justice.gov/opa/press-release/file/928496/download).
[31] *Id.* at p. 8.
[32] *Ibid.*

Suisse continued to buy loans from Resource Bank throughout the rest of 2005, 2006, and 2007…[33]

- Credit Suisse employees expressed concern that loans with inflated appraisals were being approved as within its tolerances. For example, in August 2006, Credit Suisse's Head of Credit and Underwriting emailed two Credit Suisse senior traders in connection with loans Credit Suisse was buying from Accredited Home Lenders. He wrote, "20+% of their loans have value issues > 20% off – that is unheard of. [Accredited] is acknowledging that their values are inflated. There should be a 0% variance from an originator[']s standpoint. [Accredited] is saying that [it] knows and is okay with [its] values being off by up to 15%. Some would say this is predatory and criminal. How would investors react if we say that 20% of the pool have values off by 15%? If we are comfortable buying these loans, we should be comfortable telling investors." [34]

- Credit Suisse employees observed in emails that the quality control results showed problems with the loans. A senior Credit Suisse trader wrote in a January 2007 email to one of the Co-Heads of the Structured Products Group, regarding Correspondent channel loans, "when we have a competent QC firm do an underwriting review, they flag all kinds of errors that our fullfillment [sic] centers did not catch. Moreover, our very own underwriting group agrees with the QC firm rather than our fullfillment [sic] center. I think a lot of the problems stem from the fact that our conduit and underwriting group send mixed messages. One [sic] on the one hand they profess horror that our deals are defaulting like banana republics, but on the other hand every time we try to tighten up our underwriting processes they push back claiming it makes us uncompetitive. Here are our takeaways: 1) Our fullfillment [sic] process is broken. Either they don't know how to do their jobs, or they don't report defects because the conduit doesn't want them to create waves. 2) Our underwriting group needs independence. 3) Our conduit needs to spend less time marketing to sales, and more time looking at the gross operation defects of our business." [35]

Deutsche Bank:

- Indeed, in May 2006, the Diligence Supervisor warned a senior Trader on the Subprime Desk, a Managing Director (hereinafter, "Trader 1"), that Option One, a large mortgage loan originator, was making such "aggressive" revisions to its underwriting guidelines that it would underwrite a loan to anyone with "half a pulse":

> [T]his is almost becoming a weekly event with OOMC [Option One]. The revisions [ ] are very aggressive and I would not approve. Allowing a borrower with no credit history to be upgraded to an A with a 90% LTV is unbelievable. I once heard that OOMC will approve anyone with a pulse – I would move that to half a pulse.[36]

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[33] *Id.* at p. 11.
[34] *Id.* at p. 13.
[35] *Id.* at pp. 16-17.
[36] United States Department of Justice, Settlement Agreement between Deutsche Bank and the United States, "Annex 1 - Statement of Facts", January 17, 2017, p. 10. (https://www.justice.gov/opa/press-release/file/927271/download).

- Moreover, the Diligence Supervisor remarked that one could "drive your truck through the guidelines" of certain originators from which Deutsche Bank was purchasing pools of loans.[37]

- However, after Clayton's due diligence review, the Diligence Supervisor assured Trader 1 and a Contract Finance Director in the RMBS department on a phone call that he would reduce the high reject rate of the loans in the pool despite their defects. The Diligence Supervisor stated on the call, "if you want to get to [a] 10 [percent rejection rate], I can get to 10," even though he said the pool "is a very adverse pool, we got [FICO] drifts in the 400s, I mean we've got a lot of shit in that pool trust me." By the end of the due diligence Review, the Diligence Supervisor reduced the rejection rate of the pool to 12%, and told Trader 1 that "[w]e provided a significant amount of flexibility just to get to these percentages . . . ."[38]

- At the conclusion of the review, Deutsche Bank's Diligence Supervisor informed a senior Hybrid ARMs Alt-A Mortgage Loan Trader, a Managing Director (hereinafter, "Trader 2"), that

  > [t]his Alt-A/Alt-B pool was the most adverse Alt pool I have seen in 4 years - many of the loans were defaulting on mortgages . . . and I believe RFC adversely selected this pool. I've been doing RFC securitization reviews for years and have never encountered anything like the loans found in this pool.[39]

- Indeed, in 2006 and 2007, Deutsche Bank's Diligence Supervisor believed that "most (if not all) Stated Wage Earner loans have inflated incomes," and the Subprime MD commented that "borrower or broker fraud is rampant on these" types of loans.[40]

- As a result, Deutsche Bank did not review 85% of a pool of loans that the Diligence Supervisor described as "some of the most adverse loans [he] ha[d] seen in any Alt-A pool" by January 2007.[41]

- The Diligence Supervisor subsequently "found a number of very adverse loans from both a Credit (refreshed credit scores) and Value (ran through AVM model) perspective" in the substitute pool. In particular, he explained that "[a]pproximately 30% of the upsize were loans that had a 60 days late or greater (90+, 120+) on the mortgage in the last 12 months or have a FICO score less than 550. This is a very large percentage of adverse loans for a subprime pool."[42]

- Similarly, only a few months earlier, the Diligence Supervisor informed the Subprime MD that, after completing valuation diligence on a $1 billion pool of New Century loans and

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[37] *Id.* at p. 11.
[38] *Id.* at pp. 14-15.
[39] *Id.* at p. 16.
[40] *Id.* at p. 20.
[41] *Id.* at p. 21.
[42] *Ibid.*

rejecting what loans they could, Deutsche Bank was "left with loans where the value is less than the loan amount." The Subprime MD replied that he was troubled that the Bank was "buying loans where it seems the BPO value is less than the loan amount."[43]

- For this reason, the Diligence Supervisor suggested that Deutsche Bank intentionally limit what it learned about the loans it was considering for securitization, by limiting "our sample sizes to less than 300 loans."[44]

- Specifically, on January 16, 2006, the Diligence Supervisor observed in a discussion with Clayton that "Chapel's valuation process has serious issues" and that "appraised values are very distorted." In a later January conversation with Clayton, the Diligence Supervisor more pointedly stated that Chapel's "appraisers are trying to mislead us as often as they can" and that "Chapel purposely put loans that were rejected by another investor due to inflated values into [the] pool" from which loans were taken to securitize into ACE 2006-HE2.[45]

- As the Diligence Supervisor stated to Trader 2 and the Mortgage Finance MD in May 2007 after describing the trend of increasing valuation problems, "[w]e are finding ourselves going back quite often and clearing large numbers of loans [with inflated appraisals] to bring down the deletion percentages. I expect this trend to continue through the year." But Trader 2 was well aware that Deutsche Bank was expanding its risk tolerance in order to keep originators happy and thereby keep production of loans flowing. For example, despite the Diligence Supervisor's belief that AHM appraisals went "beyond misrepresentation into the fraudulent area," in late 2006 and early 2007, Trader 2 instructed the Diligence Supervisor to expand the Bank's variance tolerance from -15% to -20% with regard to AHM loans (which numbered in the hundreds of millions of dollars in the first quarter of 2007) so that AHM would continue doing business with the Bank.[46]

Goldman Sachs:

- Goldman's Mortgage Capital Committee typically received memoranda detailing each proposed securitization, including summaries of Goldman's due diligence results for certain of the loan pools backing the securitization. Despite the high numbers of loans that Goldman had dropped from the loan pools, the Mortgage Capital Committee approved every RMBS that was presented to it between December 2005 and 2007.[47]

- The Goldman employee overseeing the due diligence for that pool also noted that the pool included loans originated with "[e]xtremely aggressive underwriting" and "large program exceptions made without compensating factors."[48]

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[43] *Id.* at p. 36.
[44] *Id.* at p. 38.
[45] *Id.* at pp. 40-41.
[46] *Id.* at p. 48.
[47] United States Department of Justice, Settlement Agreement between Goldman Sachs and the United States, "Annex 1 - Statement of Facts", April 11, 2016, p. 6. (https://www.justice.gov/opa/file/839901/download).
[48] *Id.* at p. 9.

- Although a Goldman due diligence employee reported that Countrywide had "identified the glitch and corrected it," a Goldman salesperson responsible for Countrywide nevertheless stated that this issue was "absolutely unacceptable" and "potentially actionable," and "should be elevated to senior [C]ountrywide personnel." Two Goldman employees, including the employee responsible for compliance due diligence issues, responded "I agree."[49]

- On April 11, 2006, while Goldman was preparing one of the GSAA offerings backed by loans from the March 30 Countrywide pools for securitization, a Goldman mortgage department manager circulated to a large group of Goldman employees a "very bullish" equity research report regarding Countrywide's common stock, which recommended the purchase of Countrywide shares and highlighted that Countrywide's March 2006 loan origination volume had exceeded expectations. Goldman's head of due diligence, who had just overseen Goldman's due diligence on six Countrywide pools that closed during a two-day period at the end of March, responded to the research report by saying: "If they only knew . . . ."[50]

JP Morgan (including Bear Stearns and Washington Mutual):

- Prior to JPMorgan purchasing the loans, a JPMorgan employee who was involved in this particular loan pool acquisition told an Executive Director in charge of due diligence and a Managing Director in trading that due to their poor quality, the loans should not be purchased and should not be securitized. After the purchase of the loan pools, she submitted a letter memorializing her concerns to another Managing Director, which was distributed to other Managing Directors. JPMorgan nonetheless securitized many of the loans. None of this was disclosed to investors.[51]

- Bear Stearns personnel, including certain managers, were aware that FlowConduit Securities included a number of loans from poorly graded Flow-Conduit Sellers, and were likewise aware that the loans originated by these poorly graded sellers sometimes experienced high rates of default. At least one Bear Stearns employee questioned the continued inclusion of loans from those sellers in Flow-Conduit Securities.[52]

- In certain circumstances, Bear Stearns due diligence managers or other employees determined after their review of the loans that, notwithstanding a vendor's identification of exceptions to specified underwriting guidelines, Bear Stearns would purchase loans where there was a variance from the guidelines that the managers or other employees deemed acceptable.[53]

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[49] *Id.* at pp. 10-11.
[50] *Id.* at p. 11.
[51] United States Department of Justice, Settlement Agreement between JPMorgan (including Bear Stearns and Washington Mutual) and the United States, "Annex 1 - Statement of Facts", November 19, 2013, pp. 6. (https://www.justice.gov/iso/opa/resources/94320131119151031990622.pdf).
[52] *Id.* at p. 9.
[53] *Id.* at p. 10.

Morgan Stanley:

- On May 31, 2006, a member, a member of the valuation due diligence team stated that, as to New Century's most recent pool, "a greater number of file were 'removed' during the mitigation process based on a slightly higher risk tolerance." In a reply email, the head of the valuation due diligence stated "please do not mention that 'slightly higher risk tolerance' in these communications. We are running under the radar and do not want to document these types of things." In an email exchange in June 2006 regarding loans from previous month's loan pool, one valuation team member wrote that "[o]ur team pulled in everything possible, so the loans that were kicked are the worst of the worst."[54]

- For example, in a November 21, 2006 email, a member of the valuation due diligence team sent a list of loans marked for tie-out to the head of valuation due diligence, adding, "I assume you will want to do your 'magic' on this one?"[55]

- Starting in April 2006, Morgan Stanley's finance team, which was responsible for purchasing and securitizing loan pools but not underwriting or due diligence, instituted a procedure whereby the finance team considered certain loans that Morgan Stanley's credit-and-compliance due diligence process had already recommended should not be purchased.[56]

- In March 2006, the head of Morgan Stanley's valuation due diligence team reported that, "due to the deteriorating appraisal quality they are finding with all of the sellers," his team was "not able to mitigate as many loans as they use[d] to be able to during this process."[57]

- After describing the loans rejected by Morgan Stanley from an October 2005 New Century pool, a Morgan Stanley credit-and-compliance field due diligence manager reported to the banker team that "there [was] not a lot of 'common sense' being used when approving these types of [New Century] loans."[58]

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[54] United States Department of Justice, Settlement Agreement between Morgan Stanley and the United States, "Annex 1 - Statement of Facts", February 11, 2016, p. 9. (https://www.justice.gov/opa/file/823671/download).
[55] *Id.* at p. 10.
[56] *Id.* at p. 12.
[57] *Id.* at p. 14.
[58] *Ibid.*