DEPARTMENT OF JUSTICE

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PRESS RELEASE

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HSBC Agrees To Pay $765 Million In Connection With Its Sale Of Residential Mortgage-Backed Securities

DENVER – U.S. Attorney Bob Troyer announced today that HSBC will pay $765 million to settle claims related to its packaging, securitization, issuance, marketing and sale of residential mortgage-backed securities (RMBS) between 2005 and 2007. During this period, federally-insured financial institutions and others suffered major losses from investing in RMBS issued and underwritten by HSBC. Under the settlement, HSBC will pay the $765 million as a civil penalty pursuant to the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA).

"HSBC made choices that hurt people and abused their trust," said Bob Troyer, United States Attorney for the District of Colorado. "HSBC chose to use a due diligence process it knew from the start didn't work. It chose to put lots of defective mortgages into its deals. When HSBC saw problems, it chose to rush those deals out the door. When deals went south, investors who trusted HSBC suffered. And when the mortgages failed, communities across the country were blighted by foreclosure. If you make choices like this, beware. You will pay."

"The actions of HSBC resulted in significant losses to investors, which purchased the HSBC Residential Mortgage-Backed Securities backed by defective loans," said Associate Inspector General Jennifer Byrne of the Federal Housing Finance Agency-Office of Inspector General (FHFA-OIG). "We are proud to have partnered with the U.S Attorney's Office for the District of Colorado on this matter."

FIRREA authorizes the federal government to seek civil penalties against financial institutions that violate various predicate offenses, including wire and mail fraud. The United States alleged that HSBC violated FIRREA by misrepresenting to investors the quality of its RMBS and the due diligence procedures it claimed it would use to ensure that quality. The United States' allegations are described in the settlement agreement at paragraph 3.

The United States alleged that HSBC had a due diligence process for reviewing the loans HSBC planned to securitize as RMBS, but as early as 2005, an HSBC credit risk manager expressed concerns with HSBC's due diligence process. HSBC nevertheless touted its due diligence process to potential investors. It told investors that when it purchased pools of subprime loans, HSBC would review at least 25% of the loans in the pool for credit and compliance. It told investors that it selected 20% of the loan pool as an "adverse sample" based on "a proprietary model, which will risk-rank the mortgage loans in the pool." But on some loan pools, HSBC's RMBS trading desk influenced how the risk management group selected loans for the adverse portion of the sample, and as a result, the sample was not based on its model. HSBC also told investors that it selected another 5% of the loan pool as a "random sample." But in some instances, HSBC used a random sample that was less than 5% of the pool, or used a sample that was not random at all.

To review the loans HSBC did select for review, HSBC used due diligence vendors, and HSBC saw the results of the vendors' reviews of the loans before the deals were issued. Over a one-and-a-half year period, between January 2006 and June 2007, HSBC's primary due diligence vendor flagged over 7,400 loans as having low grades—more than one out of every four loans the vendor reviewed for HSBC during that time. When HSBC employees saw loans with low grades, they sometimes "waived" those loans through or recategorized the grades to make the due diligence "percentages look better." They also expressed views about the deals they were issuing. For example, in 2007, an HSBC trader said, in reference to an RMBS that HSBC was about to issue, "it will suck."

For a loan pool HSBC purchased in 2006, HSBC learned of what employees referred to as an "abnormally large" and "alarmingly" high number of payment defaults. HSBC had purchased the loan pool but had not securitized it yet. Early payment defaults (EPDs)—when a borrower fails to make one of the first few payments on a mortgage—could be, in the words of HSBC's co-head of RMBS, "an indicator of higher expected loss on the pool." In an internal email, HSBC's head of risk management for RMBS wrote that the high EPD rate could be a sign of systemic problems with the pool. Others within HSBC's risk management group expressed concern that the pool "may be contaminated" and asked whether "they should hold back on the securitization launch until there is further clarity on all the issues…." The next day, the head of HSBC's whole loan trading risk management group stated that he was "comfortable that we need not make any further disclosures to investors…." HSBC issued the securitization a few days later. A later post-close quality control review indicated that loans that "appear to have fraud or misrep" went into the securitization. HSBC went on to buy and securitize more loans from the same originator, even after the head of HSBC's due diligence team concluded that the originator had offered "bad collateral."

After purchasing certain loan pools, HSBC ordered a quality control review but did not wait for the final results before issuing the securitization. On two pools, HSBC received preliminary quality control results before the issuance of the securitization that, according to the quality control vendor, showed indications of fraud in the origination of particular loans, but included those loans in the RMBS anyway. On a loan pool in 2007, HSBC performed post-close due diligence on a sample of loans from that pool. HSBC's due diligence vendor graded approximately 30% of the loans in the post-close due diligence sample as having the lowest grade. HSBC went on to securitize loans from that same pool without any further credit or compliance review before securitization.

These are allegations only, which HSBC disputes and does not admit.

Assistant U.S. Attorneys Kevin Traskos, Jasand Mock, Ian J. Kellogg, Hetal J. Doshi, and Lila M. Bateman of the District of Colorado investigated this matter, with the support of the Federal Housing Finance Agency's Office of the Inspector General (FHFA-OIG).

To report RMBS fraud, go to: http://www.stopfraud.gov/rmbs.html.

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