(c) Gemstone Risks and Poor Quality Assets

Gemstone 7's assets were assembled in late 2006 and early 2007, when the mortgage market was deteriorating and subprime mortgages were experiencing record delinquency rates. The CDO posed a host of risks due to both the state of the market and the poor quality of many of its underlying assets.

Credit Report. In December 2006, Mr. Lamont's CDO Group prepared a Credit Report for Deutsche Bank's credit risk management group to obtain internal approval for the securitization of Gemstone 7.[1390] The Credit Report noted the following business risks for Deutsche Bank regarding Gemstone 7, including the possibility that the bank would be unable to sell $400 million of the Gemstone securities, which carried "significant" risk:

- "The portfolio is concentrated on RMBS obligations, with 67.6%, 20.2% and 1.9% of the RMBS exposure represented by 2005, 2006, and 2007 vintages, respectively, which results in significant vintage risk."

- "RMBS accounts for ~90.0% of the initial collateral portfolio."

- "All unsold tranches have been taken back by HBK except for the Class A-1B ($400mm). Currently, we are working with [redacted] to see if they will be interested in taking the tranche. The plan for distribution if [redacted] decides not to take the tranche, will be a senior sequential repack. The Class A-1B will be broken into two tranches. DB will take the senior part (Class A-1B(i) $200mm) and HBK will take the bottom part (Class A-1B(i) $200mm). Once the repack is setup, then DB will try to syndicate the Class A-1B(i)." [1391]

The business risks described in the internal Deutsche Bank credit report relating to "significant vintage risk" for the 2005, 2006, and 2007 vintage RMBS securities[1392]were not disclosed in the Gemstone 7 offering materials given to investors. Although the March 15, 2007 Offering Circular contained a "Risk Factor" section describing multiple risks associated with an investment in Gemstone 7, including those associated with residential asset backed securities, the Offering Circular was silent with respect to the above risks identified in the Credit Report, which were highlighted for Deutsche Bank management.

[1390] Id. See undated Gemstone 7 Securitization Credit Report, MTSS000011-13 and 12/20/2006 Gemstone 7 Securitization Credit Report, DB_PSI_00237655-71. The 12/20/2006 Credit Report appears to be an earlier version of the document.
[1391] Gemstone 7 Securitization Credit Report, MTSS000011-13.
[1392] Id.

The Offering Circular did, however, describe in detail a number of significant risks associated with RMBS securities. For example, it stated:

- "The risk of losses on residential mortgage loans is particularly relevant now. While there is always a risk of defaults or delinquencies in payment, recently losses on residential mortgage loans have been increasing and may continue to increase in the future. The losses have been most significant in respect of subprime mortgage loans but all are affected.

- A number of factors are contributing to the increase in losses. Residential property values that increased for many years are now declining. … Declining property values also exacerbate the losses due to a failure to apply adequate standards to potential borrowers. Failures to properly screen borrowers may include failures to do adequate due diligence on a borrower (including employment and income history) or the relevant property (including valuation) or failures to follow predatory lending and the other borrower-protection statutes. Increases in interest rates may also contribute to higher rates of loss. ...

- The increase in delinquencies and defaults has contributed to a declining market for mortgage loans. The declining market has, in turn, seriously impacted mortgage originators and servicers. … The financial difficulties of servicers in particular are likely to result in losses in respect of securities backed by residential mortgage loans. … At any one time, the portfolio of Residential ABS Securities may be backed by residential loans with disproportionately large aggregate principal amounts secured by properties in only a few states or regions."[1393]

These disclosures demonstrate that both HBK and Deutsche Bank were well aware of the deteriorating mortgage market and increased risks associated with RMBS and CDO securities, even as they were marketing the Gemstone 7 securities and claiming HBK had applied careful analysis in the asset selection process to ensure good quality CDO securities.

Long Beach-Fremont-New Century Bonds. A substantial portion of the cash and synthetic assets included in Gemstone 7, 30% in all, involved subprime residential mortgages issued by three subprime lenders, Long Beach, Fremont, and New Century, all known for issuing poor quality loans and securities.[1394] Loans by these lenders were among the first to collapse. According to Moody's, these three originators, plus WMC Corporation, accounted for 31% of

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[1393] 3/15/2007 Offering Circular for Gemstone CDO VII, Ltd., GEM7-00000427-816 at 483-84. While an earlier offering circular for Gemstone 7, dated February 14, 2007, identifies some risks associated with the CDO, the March offering circular contains additional language, quoted above, on the risks associated with the deteriorating mortgage market. 2/14/2007 Offering Circular for Gemstone CDO VII, Ltd., PSI-M&T_Bank-02-0001-370.

[1394] For more information on these three lenders, see sections D(3)(d) and E(2)(c)-(d) of Chapter IV. Mr. Jenks of HBK told the Subcommittee that he saw data showing that Long Beach and Fremont were poor performers, but he thought the performance varied depending upon the tranche, and he believed he could pick the better tranches. He thought he could buy low, structure the deal well, and make money. Subcommittee interview of Kevin Jenks (10/13/2010).

the subprime RMBS securities issued in 2006, but 63% of the rating downgrades issued in the second week of July 2007, when the mass rating downgrades began.[1395]

During the period when securities were being assembled for the Gemstone 7 warehouse in late 2006 and early 2007, Mr. Lippmann frequently disparaged many of the same assets he and his traders allowed to be included in Gemstone 7. About $27 million of these assets came from Deutsche Bank's own inventory. In emails to colleagues and his clients, Mr. Lippmann used words like "crap" and "pig" to describe the assets. Mr. Lippmann brought some of the assets of Gemstone 7 to the attention of some of his clients that shorted these assets.[1396]

On October 20, 2006, for example, one of Mr. Lippmann's clients sent him an email seeking advice about certain subprime bonds issued by Long Beach Mortgage Loan and Trust (LBMLT) and other originators. Mr. Lippmann responded:

> "LBMLT-06-5 M9-375. Long Beach is one of the weakest names in the market. We shorted this bond to a CDO in the mid-300s on October 13[.] Deal was done before S&P changed their criteria on July 1. Lots of 40 year mortgages …. Less than half the loans have full documentation and 10% are investor properties. This is a real pig.
>
> LBMLT -06-2 M9 350. See above on Long Beach. This one is already performing poorly with substantial delinquencies …. Further the FICO is less than the 06-05 and there are fewer full doc loans. This seems a better short than the 06-5. Only reason I can think for my guys showing you a tighter level is that we are short this one and that the June 06 deals have a taint that earlier months don[']t due to the theory that late June deals were crammed with bad stuff in order to beat the S & P revisions."[1397]

Despite these negative views of Long Beach, Mr. Lippmann's group raised no concerns when $25 million in LBMLT 2006-5 M9 securities was purchased by HBK for Gemstone 7's warehouse account, $20 million of which was purchased on October 24, 2006, four days after Mr. Lippmann's email. Altogether, a total of $79.5 million in Long Beach bonds went into Gemstone 7.[1398]

Mr. Lippmann had similar negative views of RMBS securities containing subprime loans originated by Fremont, yet his group did not object to including Fremont securities in Gemstone 7. For instance, on December 6, 2006, Mr. Lippmann's traders did not object to including $20 million of an RMBS known as SABR 2005-FR4 B3, which contained Fremont loans, in Gemstone 7.[1399] One week earlier, on November 29, 2006, when asked by a bank colleague

[1395] 7/12/2007 Moody's Structured Finance Teleconference and Web Cast: RMBS and CDO Rating Actions, at Moody's SI 2010-0046902, Hearing Exhibit 4/23-106.
[1396] Subcommittee interview of counsel for Deutsche Bank (2/1/2011).
[1397] 10/20/2006 email from Greg Lippmann to Craig Carlozzi at Mast Capital, DBSI_PSI_EMAIL01774820-21.
[1398] 9/14/2010 Gemstone 7 Asset Chart, PSI-DeutscheBank-17-Gemstone7-0001-03.
[1399] Id.