

Employees at Freddie Mac should be in jail for this:

Freddie Mac Bets Against American Homeowners

by [Jesse Eisinger](#), ProPublica and [Chris Arnold](#), NPR News Jan. 30, 2012, 5 a.m.



(AFP/Getty Images)

Did Your Bank Wrongfully Seek to Foreclose on You?

This story was co-published with [NPR News](#) [2].

Freddie Mac, the taxpayer-owned mortgage giant, has placed multibillion-dollar bets that pay off if homeowners stay trapped in expensive mortgages with interest rates well above current rates.

Freddie began increasing these bets dramatically in late 2010, the same time that the company was making it harder for homeowners to get out of such high-interest mortgages.

No evidence has emerged that these decisions were coordinated. The company is a key gatekeeper for home loans but says its traders are “walled off” from the officials who have restricted homeowners from taking advantage of historically low interest rates by imposing higher fees and new rules.

Freddie’s charter calls for the company to make home loans more accessible. Its chief executive, Charles Haldeman Jr., recently told Congress that his company is “helping financially strapped families reduce their mortgage costs through refinancing their mortgages.”

But the trades, uncovered for the first time in an investigation by ProPublica and NPR, give Freddie a powerful incentive to do the opposite, highlighting a conflict of interest at the heart of the company. In addition to being an instrument of government policy dedicated to making home loans more accessible, Freddie also has giant investment portfolios and could lose substantial amounts of money if too many borrowers refinance.

“We were actually shocked they did this,” says Scott Simon, who as the head of the giant bond fund PIMCO’s mortgage-backed securities team is one of the world’s biggest mortgage bond traders. “It seemed so out of line with their mission.”

The trades “put them squarely against the homeowner,” he says.

Those homeowners have a lot at stake, too. Many of them could cut their interest payments by thousands of dollars a year.

Freddie Mac, along with its cousin Fannie Mae, was bailed out in 2008 and is now owned by taxpayers. The companies play a pivotal role in the mortgage business because they insure most home loans in the United States, making banks likelier to lend. The companies’ rules determine whether homeowners can get loans and on what terms.

The Federal Housing Finance Agency effectively serves as Freddie’s board of directors and is ultimately responsible for Freddie’s decisions. It is run by acting director Edward DeMarco, who cannot be fired by the president except in extraordinary circumstances.

Freddie and the FHFA repeatedly declined to comment on the specific transactions.

Freddie’s moves to limit refinancing affect not only individual homeowners but the entire economy. An expansive refinancing program could help millions of homeowners, some economists say. Such an effort would “help the economy and put tens of billions of dollars back in consumers’ pockets, the equivalent of a very long-term tax cut,” says real-estate economist Christopher Mayer of the Columbia Business School. “It also is likely to reduce foreclosures and benefit the U.S. government” because Freddie and Fannie, which guarantee most mortgages in the country, would have lower losses over the long run.

Freddie Mac’s trades, while perfectly legal, came during a period when the company was supposed to be reducing its investment portfolio, according to the terms of its government takeover agreement. But these trades escalate the risk of its portfolio, because the securities Freddie has purchased are volatile and hard to sell, mortgage securities experts say.

The financial crisis in 2008 was made worse when Wall Street traders made bets against their customers and the American public. Now, some see similar behavior, only this time by traders at a government-owned company who are using leverage, which increases the potential profits but also the risk of big losses, and other Wall Street stratagems. “More than three years into the government takeover, we have Freddie Mac pursuing highly levered, complicated transactions seemingly with the purpose of trading against homeowners,” says Mayer. “These are the kinds of things that got us into trouble in the first place.”

'We're in financial jail'



Jay and Bonnie Silverstein (Chris Arnold, NPR News)

Freddie Mac is betting against, among others, Jay and Bonnie Silverstein. The Silversteins live in an unfinished development of cul-de-sacs and yellow stucco houses about 20 miles north of Philadelphia, in a house decorated with Bonnie's orchids and their Rose Bowl parade pin collection. The developer went bankrupt, leaving orange plastic construction fencing around some empty lots. The community clubhouse isn't complete.

The Silversteins have a 30-year fixed mortgage with an interest rate of 6.875 percent, much higher than the going rate of less than 4 percent. They have borrowed from family members and are living paycheck to paycheck. If they could refinance, they would save about \$500 a month. He says the extra money would help them pay back some of their family members and visit their grandchildren more often.

But brokers have told the Silversteins that they cannot refinance, thanks to a Freddie Mac rule.

The Silversteins used to live in a larger house 15 minutes from their current place, in a more upscale development. They had always planned to downsize as they approached retirement. In 2005, they made the mistake of buying their new house before selling the larger one. As the housing market plummeted, they couldn't sell their old house, so they carried two mortgages for 2½ years, wiping out their savings and 401(k). "It just drained us," Jay Silverstein says.

Finally, they were advised to try a short sale, in which the house is sold for less than the value of the underlying mortgage. They stopped making payments on the big house for it to go through. The sale was finally completed in 2009.

Such debacles hurt a borrower's credit rating. But Bonnie has a solid job at a doctor's office, and Jay has a pension from working for more than two decades for Johnson & Johnson. They say they haven't missed a payment on their current mortgage.

But the Silversteins haven't been able to get their refi. Freddie Mac won't insure a new loan for people who had a short sale in the last two to four years, depending on their financial condition. While the company's previous rules prohibited some short sales, in October 2010 the company changed its criteria to include all short sales. It is unclear whether the Silverstein mortgage would have been barred from a short sale under the previous Freddie rules.

Short-term, Freddie's trades benefit from the high-interest mortgage in which the Silversteins are trapped. But in the long run, Freddie could benefit if the Silversteins refinanced to a more affordable loan. Freddie guarantees the Silversteins' mortgage, so if the couple defaults, Freddie

— and the taxpayers who own the company — are on the hook. Getting the Silversteins into a more affordable mortgage would make a default less likely.

If millions of homeowners like the Silversteins default, the economy would be harmed. But if they switch to loans with lower interest rates, they would have more money to spend, which could boost the economy.

“We’re in financial jail,” says Jay, “and we’ve never been there before.”

How Freddie's investments work

Here's how Freddie Mac's trades profit from the Silversteins staying in “financial jail.” The couple's mortgage is sitting in a big pile of other mortgages, most of which are also guaranteed by Freddie and have high interest rates. Those mortgages underpin securities that get divided into two basic categories.

Anatomy of a Deal

How Freddie Mac structured a deal in which it profited if homeowners stayed trapped in high-interest mortgages.

One portion is backed mainly by principal, pays a low return, and was sold to investors who wanted a safe place to park their money. The other part, the inverse floater, is backed mainly by the interest payments on the mortgages, such as the high rate that the Silversteins pay. So this portion of the security can pay a much higher return, and this is what Freddie retained.

In 2010 and '11, Freddie purchased \$3.4 billion worth of inverse floater portions — their value based mostly on interest payments on \$19.5 billion in mortgage-backed securities, according to prospectuses for the deals. They covered tens of thousands of homeowners. Most of the mortgages backing these transactions have high rates of about 6.5 percent to 7 percent, according to the deal documents.

Between late 2010 and early 2011, Freddie Mac's purchases of inverse floater securities rose dramatically. Freddie purchased inverse floater portions of 29 deals in 2010 and 2011, with 26 bought between October 2010 and April 2011. That compares with seven for all of 2009 and five in 2008.

In these transactions, Freddie has sold off most of the principal, but it hasn't reduced its risk.

First, if borrowers default, Freddie pays the entire value of the mortgages underpinning the securities, because it insures the loans.

It's also a big problem if people like the Silversteins refinance their mortgages. That's because a refi is a new loan; the borrower pays off the first loan early, stopping the interest payments. Since the security Freddie owns is backed mainly by those interest payments, Freddie loses.

And these inverse floaters burden Freddie with entirely new risks. With these deals, Freddie has taken mortgage-backed securities that are easy to sell and traded them for ones that are harder and possibly more expensive to offload, according to mortgage market experts.

The inverse floaters carry another risk. Freddie gets paid the difference between the high mortgage rates, such as the Silversteins are paying, and a key global interest rate that right now is very low. If that rate rises, Freddie's profits will fall.

It is unclear what kinds of hedging, if any, Freddie has done to offset its risks.

At the end of 2011, Freddie's portfolio of mortgages was just over \$663 billion, down more than 6 percent from the previous year. But that \$43 billion drop in the portfolio overstates the risk reduction, because the company retained risk through the inverse floaters. The company is well below the cap of \$729 billion required by its government takeover agreement.

How Freddie tightened credit

Restricting credit for people who have done short sales isn't the only way that Freddie Mac and Fannie Mae have tightened their lending criteria in the wake of the financial crisis, making it harder for borrowers to get housing loans.

Some tightening is justified because, in the years leading up to the financial crisis, Freddie and Fannie were too willing to insure mortgages taken out by people who couldn't afford them.

In a statement, Freddie contends it is "actively supporting efforts for borrowers to realize the benefits of refinancing their mortgages to lower rates."

The company said in a statement: "During the first three quarters of 2011, we refinanced more than \$170 billion in mortgages, helping nearly 835,000 borrowers save an average of \$2,500 in interest payments during the next year." As part of that effort, the company is participating in an Obama administration plan, called the Home Affordable Refinance Program, or HARP. But critics say HARP could be reaching millions more people if Fannie and Freddie implemented the program more effectively.

Indeed, just as it was escalating its inverse floater deals, it was also introducing new fees on borrowers, including those wanting to refinance. During Thanksgiving week in 2010, Freddie quietly announced that it was raising charges, called post-settlement delivery fees.

In a recent white paper on remedies for the stalled housing market, the Federal Reserve criticized Fannie and Freddie for the fees they have charged for refinancing. Such fees are "another possible reason for low rates of refinancing" and are "difficult to justify," the Fed wrote.

A former Freddie employee, who spoke on condition he not be named, was even blunter: "Generally, it makes no sense whatsoever" for Freddie "to restrict refinancing" from expensive loans to ones borrowers can more easily pay, since the company remains on the hook if homeowners default.

In November, the FHFA announced that Fannie and Freddie were eliminating or reducing some fees. The Fed, however, said that "more might be done."

The regulator as owner

The trades raise questions about the FHFA's oversight of Fannie and Freddie. But the FHFA is not just a regulator. With the two companies in government conservatorship, the FHFA now plays the role of their board of directors and shareholders, responsible for the companies' major decisions.

Under acting director DeMarco, the FHFA has emphasized that its main goal is to limit taxpayer losses by managing the two companies' giant investment portfolios to make profits. To cover their previous losses and ongoing operations, Fannie and Freddie already had received \$169 billion from taxpayers through the third quarter of last year.

The FHFA has frustrated the administration because the agency has made preserving the value of the companies' investment portfolios a priority over helping homeowners in expensive mortgages. In 2010, President Barack Obama nominated a permanent replacement for acting director DeMarco, but Republicans in Congress blocked him. Obama has not nominated anyone else to replace DeMarco.

Even though Freddie is a ward of the state, top executives are highly compensated. Peter Federico, who's in charge of the company's investment portfolio, made \$2.5 million in 2010, and he had target compensation of \$2.6 million for last year, when most of these leveraged investments were made.

One of Federico's responsibilities — tied to his bonuses — is to “support and provide liquidity and stability in the mortgage market,” according to Freddie's annual filing with the Securities and Exchange Commission. Mortgage experts contend that the inverse floater trades don't further that goal.

ProPublica and NPR made numerous attempts to reach Federico. A woman who answered his home phone said he declined to comment.

The FHFA knew about the trades before ProPublica and NPR approached the regulatory agency about them, according to an FHFA official. The FHFA has the power to approve and disapprove trades, though it doesn't involve itself in day-to-day decisions. The official declined to comment on whether the FHFA knew about them as Freddie was conducting them or whether the FHFA had explicitly approved them.