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Freddie Mac Bets Against Homeowners and Refinancing

Freddie Mac has again entered the spotlight as a new report claims the government-sponsored enterprise betrayed American homeowners after placing multibillion-dollar bets that will pay off if homeowners remain shackled by costly mortgages with interest rates well above current rates. In a scathing new revelation of their investigation, National Public Radio (NPR) and ProPublica, an independent investigative news service, uncovered multibillion-dollar investments made by Freddie in late 2010 that will pay off only if homeowners remain trapped in high-interest mortgages.

In effect, while the taxpayer-owned mortgage giant is helping consumers secure mortgages, at the same time it is making those mortgages more difficult to refinance.

Not only do these investments clash with Freddie's public mandate, the report also found that the company has substantially inflated the size of its investment portfolio. Under provisions stipulated in a 2008 bailout contract — which along with its cousin Fannie Mae granted ownership to taxpayers — Freddie is supposed to be reducing its investment portfolio; however, the NPR-ProPublica report unveiled that the company's new securities have infused greater volatility in its portfolio. ABC News explained how such investments are administered:

> Securities owned by Freddie fall into two categories. In one are those backed mainly by principal. These pay a low return but are considered low-risk. The second category holds securities backed by mortgage interest payments only. These pay a higher rate but are considered riskier, since, if homeowner defaults, Freddie as the insurer must pay the entire value of the mortgage. Known as inverse floaters, these investments are harder for Freddie to offload onto investors.

From 2010 to 2011, Freddie expanded its catalog of "inverse floaters" by $3.4 billion, and now interest rates on the underlying mortgages reach as high as seven percent. Naturally, the company does not want borrowers to default on those mortgages, but it's also not in its best financial interest to have them shift to less expensive mortgages, because when borrowers refinance, they pay off their first loan early, and Freddie loses those plush interest payments. This is precisely why the company has imposed new rules and regulations — including high introduction fees and strict requirements on who qualifies for a Freddie-insured mortgage — as they will make it more difficult for homeowners to refinance.

Freddie explains that its job is to buy "loans from lenders to replenish their supply of funds so that they [the lenders] can make more mortgage loans to other borrowers." This is partly why Freddie Mac boasts such an expansive portfolio, containing loans which harvest income largely from mortgage payments. Further, instead of holding a simple group of loans, before the housing collapse the company used Wall Street to slice up the loans into complex securities to sell in financial markets. NPR provided a hypothetical scenario to help illustrate how such practices work:

• Freddie Mac takes, say, $1 billion worth of home loans and packages them. With the help of a Wall Street banker, it can then slice off parts of the bundle to create different investment securities, some riskier than others. The slices could be set up so that, say, $900 million worth are relatively safe investments, based upon homeowners paying the principal on their mortgages.

• But the one remaining slice, worth $100 million, is the riskiest part. Freddie retains that slice, known as an "inverse floater" [as previously described], which receives all of the interest payments from the entire $1 billion worth of mortgages.

• That riskiest investment pays out a lucrative stream of interest payments. But Freddie's slice also has all the so-called "pre-payment risk" associated with that $1 billion worth of loans. So if lots of people "pre-pay" their old loans and refinance into new, cheaper ones, then Freddie Mac starts to lose money. If people can't refinance, then Freddie wins because it continues to receive that flow of older, higher interest payments.

As the economy tumbled, interest rates plunged and millions of homeowners sought refinancing, but were unable to qualify for lower rates because lenders rejected them. Freddie Mac was one of those lenders which prevented homeowners from refinancing, while at the same time betting against the possibility of their being able to do so.

Jay and Bonnie Silverstein were two victims of Freddie's Las Vegas-like betting scheme, as they currently have a 30-year fixed mortgage with an interest rate just below seven percent, a substantial jump over the current near four-percent rate. If Jay and Bonnie were able to refinance, they would save about $500 a month, but brokers told the couple that the Freddie Mac rule was hindering them from refinancing. In 2005, the Silversteins made the mistake of purchasing their new home before selling their old one, which backfired when the housing market collapsed, leaving them with two mortgages to pay for two-and-a-half years.

In effect, Freddie Mac's artificial manipulation of the market, which helped spur the housing crisis, has left them in financial ruin — and Freddie's predicts they will stay there. "We're in financial jail," asserted Silverstein, "and we've never been there before."

Naturally, the fact that Freddie Mac's financial health strengthens when homeowners can't refinance their homes creates a conflict of interest. Simply put, "Freddie Mac prevented households from being able to take advantage of today's mortgage rates — and then bet on it," said Alan Boyce, a former bond trader who has led a campaign to endorse more home loan refinances.

Scott Simon, managing director of asset-giant PIMCO's mortgage security teams, said Freddie's devious schemes "put them squarely against the homeowner." Further, he stated, "It seemed so out of line with their mission, out of line with what Congress wanted them to do."

"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," added Christopher Mayer, an economist at the Columbia Business School. "These are the kinds of things that got us into trouble in the first place."

The revelation is expected to be chafing for President Obama, who in his State of the Union address announced reform measures which would provide homeowners with a chance to save $3,000 a year by refinancing. Moreover, it counters recent assertions by Freddie Mac chief executive Charles Haldeman, who disclosed to Congress that his company is "helping financially strapped families reduce their mortgage costs through refinancing their mortgages."

And while the company's website defines its public mission as stabilizing "the nation's residential mortgage markets [while expanding] opportunities for homeownership," the NPR-ProPublica investigation seemingly proves just the opposite.