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Feds to big banks: Pay up

By Paul McMorrow | OCTOBER 04, 2011



AP

Investments by Fannie Mae and Freddie Mac that later went sour are the basis of lawsuits the federal government has filed against major banks.

IN JUNE, 2006, Fannie Mae poured \$205 million into what was, at the time, a common deal for the mortgage company. It bought the AAA-rated top slice of a Merrill Lynch bond packed with the kinds of subprime mortgages that Fannie's own lending standards prevented it from buying. This one was special, though: It ended up being Fannie's single worst purchase of the housing boom.

Mortgages backing this bond deal failed at an obscene rate. Merrill had packaged roughly 1,200 mortgages into the bond Fannie bought, and by the time Fannie's government regulator sued Merrill last month, three out of every four loans in this deal had fallen into default. If there ever was a financial instrument custom-built to ruin an entire economy, this subprime mortgage bond was it. Now, belatedly, the government wants Merrill to pay.

The federal government is suing the country's large banks over \$200 billion in worthless mortgage securities. Small talk around the law firm conference room table must be awkward, since the federal government that is suing the likes of Citibank, Bank of America, JP Morgan, and Morgan Stanley is the very same federal government that bailed those same banks out in late 2008.

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The feds didn't have much of a choice. Private investors were clobbering Wall Street with lawsuits alleging that the mortgage securities at the heart of the economy's collapse had been packaged and sold fraudulently. Fannie Mae and Freddie Mac were the largest consumers of housing boom-vintage mortgage securities. Some \$50 billion of Fannie and Freddie's \$250 billion in losses since 2007 have come from toxic mortgage securities. And taxpayers have already sunk \$141 billion into rescuing Fannie and Freddie.

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Fannie and Freddie's federal regulator had to decide between attacking the banks the government just rescued, or standing down and letting taxpayers eat the cost of those banks' misdeeds. Their regulator chose to sue. It targeted 18 banks, and nearly 600 individual securities deals, worth \$200 billion.

During housing's go-go years, the profit-hungry Fannie and Freddie were huge buyers of anything Wall Street rolled out with a AAA rating stamped to it. This 2006 Merrill deal fit the bill, despite being the housing boom's single worst collection of loans.

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Merrill got these mortgages — \$425 million in all — from Fremont Investment and

Loan, a notorious subprime mortgage lender. Fremont and Merrill both made fees by selling mortgages down the line. Both had incentives to prioritize volume over loan quality. Fremont generated volume by stuffing marginal borrowers into loans that started with low teaser interest rates, and then adjusted upward over time. In the twisted logic of the housing boom, high interest rates down the line didn't matter, because borrowers would refinance before things got hairy, and pocket some of their ever-increasing home equity along the way. Most left borrowers with only a sliver of equity.

Merrill's underwriters assumed that all the loans in the June 2006 bond would be refinanced by mid-2012. But between 2006, when the mortgages were written, and 2008, when refinancing was supposed to forestall the escalating interest rates that followed low teasers, housing prices peaked and crashed. Borrowers who had been encouraged to cash out all their equity found themselves severely upside-down, and when the mortgages' interest rates jumped, defaults mounted.

The government isn't suing Merrill (now owned by Bank of America) over garbage results, though. It's alleging fraud, saying that Merrill and Fremont, along with the 17 other banks it's suing, overstated borrowers' incomes and inflated home valuations in SEC filings.

Merrill claimed 70 percent of borrowers in its June 2006 mortgage bond had put 20 percent down; the real number was closer to 40 percent, while nearly 20 percent of the mortgages in the deal were upside-down from day one. Fremont only bothered to verify the documentation on half the loans in the deal. These misstatements led to deals that ranged from catastrophic to just pretty awful. One in every five deals covered by the feds' lawsuits saw mortgage defaults in excess of 60 percent. Nearly four in five deals had default rates over 40 percent. It's tough to see those numbers and not cheer for legal retribution. Too big to fail shouldn't also mean too big to be held accountable.

Paul McMorrow is an associate editor at CommonWealth Magazine. His column appears regularly in the Globe.