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### Freddie Mac's Loan Deal With Bank of America Is Called Flawed



Daniel Rosenbaum for The New York Times

Steve A. Linick, the Federal Housing Finance Agency's inspector general, oversaw the report.

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Freddie Mac used a flawed analysis when it accepted \$1.35 billion from Bank of America to settle claims that the bank misled it about loans purchased during the mortgage boom, according to an oversight report scheduled for release on Tuesday.

The faulty methodology significantly increased the probable losses in Freddie Mac's portfolio of loans, according to the report, prepared by the inspector general of the Federal Housing Finance Agency, which oversees the company. Freddie Mac and Fannie Mae were taken over by the government in 2008 so additional losses would be shouldered by taxpayers.

The report also noted that the settlement with Bank of America in December was completed over the objections of a senior examiner at the agency. Freddie Mac officials did not want to jeopardize the company's relationship with Bank of America, from which it continues to buy loans, the report concluded.

The agency official who questioned the loan review methodology contended that Freddie Mac's analysis greatly underestimated the number of dubious loans bought from the Countrywide unit of Bank of America from 2005 to 2007. The deal between Freddie Mac and the bank resolved claims associated with 787,000 loans, some of which were repurchased by the bank, and cannot be rescinded.

"An effective mortgage repurchase process is critical in limiting the enterprises', and ultimately, the taxpayers' exposure to credit losses resulting from the financial crisis," said Steve A. Linick, the inspector general who oversaw the report. "F.H.F.A. and Freddie Mac must do more to ensure that high-dollar settlements of repurchase claims are accurately estimated and in the best interests of taxpayers."

When selling loans to Freddie Mac and Fannie Mae, Countrywide and other originators vouched that the mortgages met certain quality standards or characteristics, like accurately representing a

borrower's income or the appraised value of a property. These promises require mortgage originators to buy back at full value those loans that do not meet the standards.

Companies often review loans for possible buybacks after experiencing large numbers of defaults. Not all defaults, of course, occur after misrepresentations.

The inspector general's report does not specify how much additional money Freddie Mac could have received from Bank of America had it used a more effective analysis. But the senior examiner who questioned the deal told the inspector general's staff that Freddie Mac's faulty process could cost the company "billions of dollars of losses."

A Freddie Mac spokesman, Douglas Duvall, declined to comment, but said that it continued to believe its deal with Bank of America was "commercially reasonable based upon our internal evaluation and judgments."

Because of the faulty methodology, Freddie Mac failed to review 100,000 loans from 2006 for possible irregularities, the report said. As of June 2010, some 93 percent of foreclosed mortgages from 2005 and 2006 had not been analyzed, eliminating "any chance to put ineligible loans back to the lenders for those years."

The report also noted that 300,000 foreclosed loans originated from 2004 to 2007 and owned by Freddie Mac were not reviewed for possible claims. These loans have a combined unpaid principal balance exceeding \$50 billion, the report said.

Freddie Mac's review process was faulty, according to the report, because it did not change its analysis to account for new types of mortgages issued during the housing boom. These included mortgages that had rock-bottom interest rates initially - known as teaser rates - lasting three years to five years before adjusting upward.

The loan review analysis used by Freddie Mac focused on mortgages that went bad within two years, because historically that had been the period during which defaults related to possible loan improprieties were most likely to occur. Reasoning that the new types of mortgages with artificially low initial rates would probably lengthen the period before large numbers of defaults occurred, the senior agency examiner urged Freddie Mac's management in June 2010 to review loans that experienced problems well after two years, the report said.

The company declined to change its methodology. At a July 2010 meeting of Freddie Mac's credit risk subcommittee, a company manager told housing finance agency staff that loan repurchase reviews were "not the highest and best use of his limited resources," the report said. Freddie Mac officials also disagreed with the concerns expressed by the senior examiner at the agency, the report said, "partly because they believed a change to a more aggressive approach to repurchase claims would adversely affect Freddie Mac's business relationships with Bank of America and other large loan sellers."

A few months later, the deal was made with Bank of America. As they considered the merits of the deal, Freddie Mac's directors were told that it would improve the company's "ongoing relationship with Bank of America."

The \$1.35 billion buyback deal was done despite questions about its review process from the company's internal auditors, the inspector general's report said.

Randy Neugebauer, a Texas Republican who leads the oversight and investigations subcommittee of the House Financial Services Committee, said: "After reading the I.G.'s report, I am concerned

that F.H.F.A. is not exercising independent judgment. The American taxpayers deserve better than business as usual, especially when they have already spent \$160 billion to keep Freddie and Fannie afloat."

The report also noted that superiors at the agency declined to help the senior examiner prod Freddie Mac to expand its review process. One of those superiors, a senior manager who was not identified, told the inspector general that he had not opened the attachment to an e-mail from the senior examiner outlining problems with the company's methodology.

Responding to the inspector general's report, the agency said it continued to believe that the Bank of America settlement was "appropriate and reasonable." But the agency agreed that it lacked policies and procedures where "an examiner has a safety and soundness concern" but encountered resistance in pursuing it. The agency said it would soon issue such policies.

The Federal Housing Finance Agency has suspended all future mortgage repurchase settlements affected by the methodology underlying Freddie Mac's loan review process.

Last June, Freddie Mac's internal auditors advised the company that its controls regarding the loan review process were "unsatisfactory" and said that "opportunities for increasing the repurchase benefit justify an expansion of our sampling approach" after the second year of the loan, the report said. A company official told the Freddie Mac directors that a more in-depth loan review could generate as much as \$1 billion in additional revenue.

Two months ago, Freddie Mac began a more rigorous review of foreclosed, interest-only loans. In late August, it told the housing finance agency staff that the study showed 15 percent of the sampled loans - a higher figure than that in the Bank of America settlement - contained defects that might result in buybacks among originators.

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