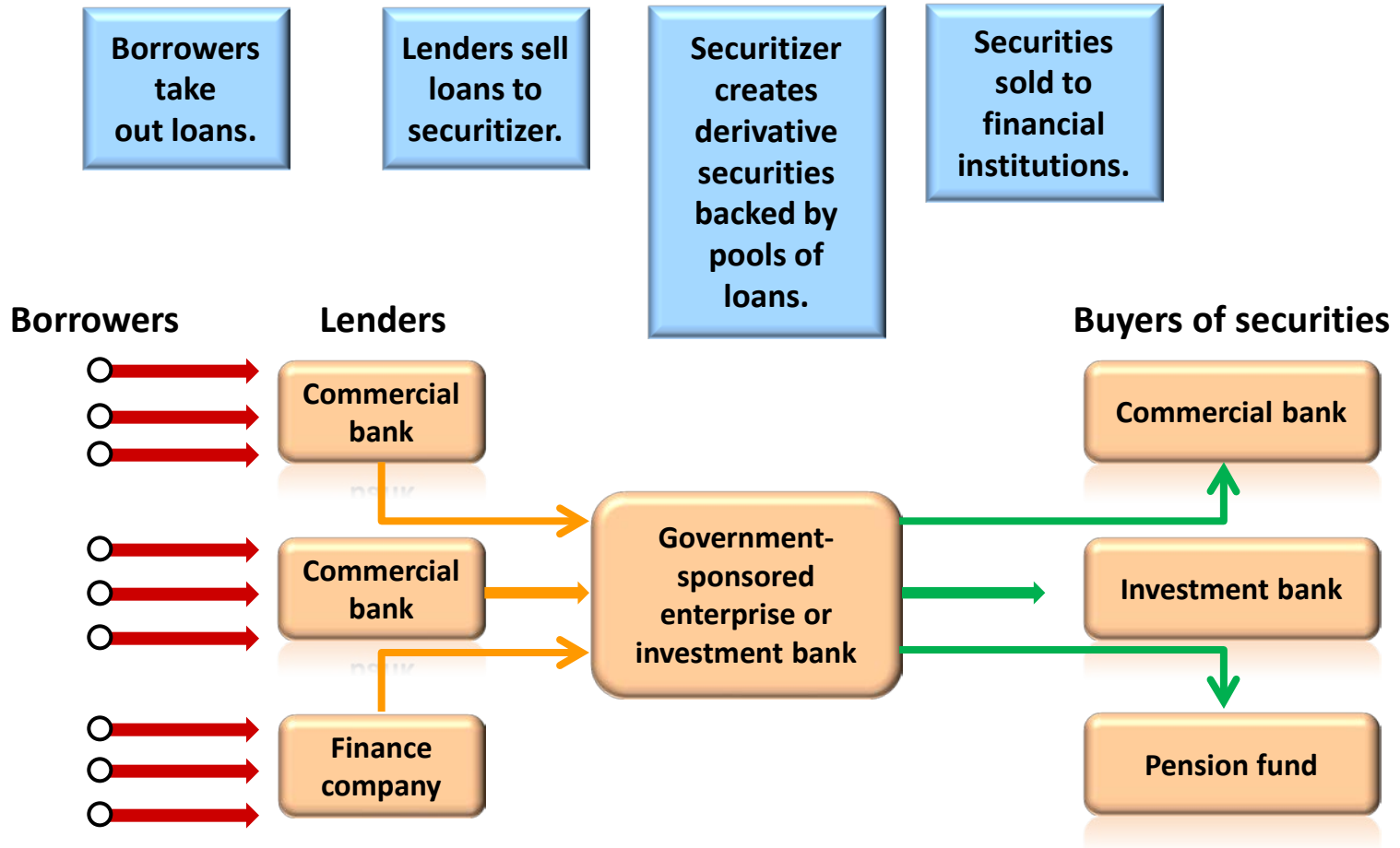


The Securitization Process





Freddie Mac

Freddie Mac Securitization, "inverse floating" and conflicts of interest

This hypothetical example may help explain what happens:

1) 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.

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

3) 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.

If the homeowner is unable to refinance, the Freddie Mac portfolio managers win, Simon says. "And if the homeowner can refinance, they lose."

Case Study: Subprime Mortgage Fiasco

- The 2007-2009 financial crisis stemmed from the interplay of the housing bubble, growing subprime lending, securitization and regulatory gaps.
- House prices rose 71% from 2002 to 2006, And then fell 33% through 2009.
- Subprime lenders reduced down payments for mortgage loans (sometimes to zero).
- By not requiring documentation, borrowers could exaggerate incomes, increasing the actual ratio of monthly payment size to income.
- Low *teaser rates* attracted borrowers who had difficulty making payments when rates increased after 2 or 3 years.
- The Fed banned no-documentation loans in 2008, too late to stop the crisis..

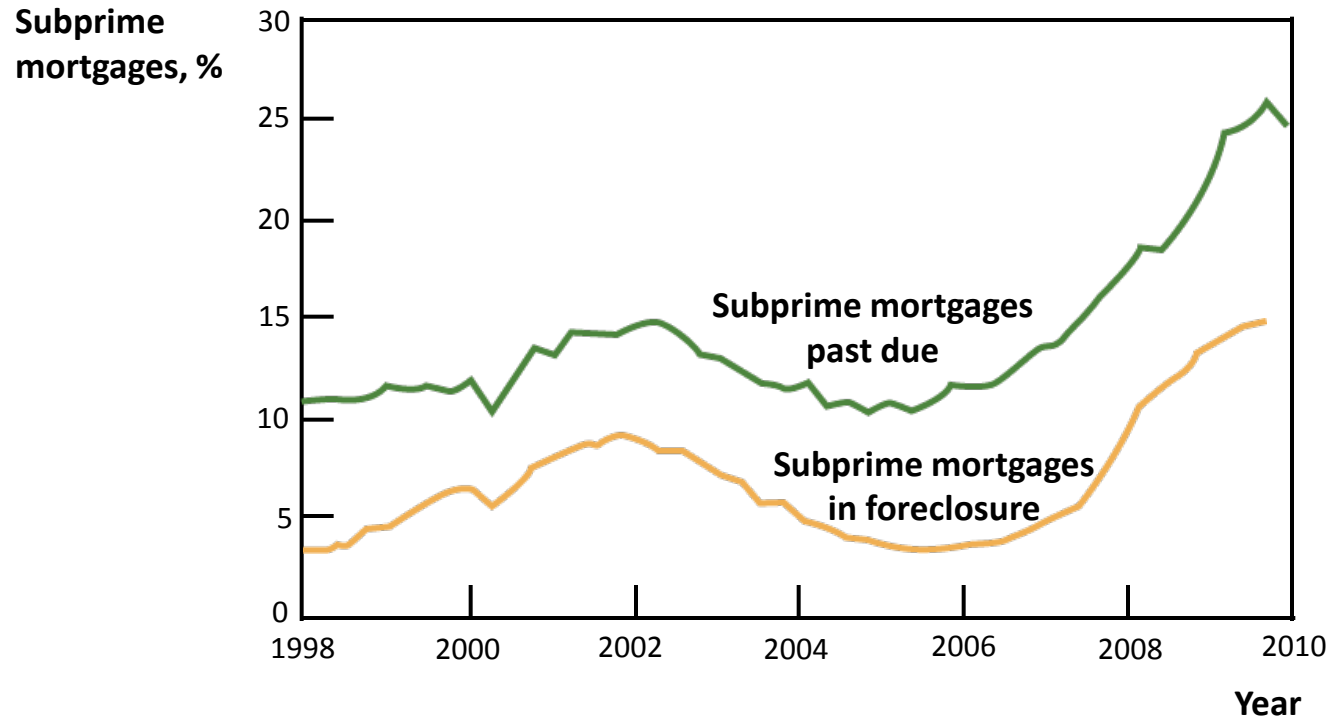
Case Study: Subprime Mortgage Fiasco

- Subprime lending was profitable in the 1990s and early 2000s.
- The Federal Reserve kept interest rates low for several years following the 2001 recession, so mortgage rates did not increase much when teaser rates ended.
- Rising home prices made it easy to cope with high mortgage payments through second mortgages or selling for a capital gain.
- Eager for profit, investment banks created and held subprime MSBs.

Case Study: Subprime Mortgage Fiasco

- House prices began falling in 2006, and homeowners found payments unaffordable, but couldn't borrow more or refinance.
- By late 2009, over 25% of subprime mortgages were delinquent and 16% were in foreclosure.
- Falling house prices affect prime mortgages, and the foreclosure rate increased from 0.4% to 1.4%.
- Millions of people lost homes, financial institutions failed or suffered large losses, stock and bond prices fell, and the economy entered a deep recession.

The Subprime Mortgage Crisis



Starting in 2006, a rising fraction of subprime mortgage borrowers fell behind on their payments. Foreclosures on subprime mortgages also rose.

Source: Mortgage Bankers Association

Source: Mortgage Bankers Association

YAHOO! FINANCE

Citigroup sued for fraud over \$1 billion of CDOs



Reuters – 1 hour 0 minutes ago

By **Karen Freifeld**

NEW YORK (Reuters) - Citigroup Inc (NYSE:[C](#) - [News](#)) was sued for fraud by Loreley Financing over nearly \$1 billion worth of collateralized debt obligations purchased in 2006 and 2007.

Citigroup is accused of defrauding Loreley into purchasing "fraudulent investments that are now worthless," Loreley said in a complaint filed Tuesday in New York State Supreme Court in Manhattan.

Citi used the CDOs to offload the risks of toxic mortgage-backed securities on its books and to help preferred clients "short" the housing market, the lawsuit claims.

Danielle Romero-Apsilos, a spokeswoman for Citigroup, said in an email, "We believe the suit is without merit."

Loreley Financing is a group of special-purpose entities formed to invest in CDOs. The entities are organized under the laws of Jersey in the Channel Islands.

The entities, whose claims include fraud and unjust enrichment, are seeking at least \$965 million paid for the notes and buybacks.

The case is Loreley Financing v. Citigroup Global Markets, 650212/2012, New York State Supreme Court.

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