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A NATION OF LIARS

Mortgage fraud, ordinary people and the Great Recession

By Julius Wachtel, (c) 2010

Four to six *billion* dollars. That's what mortgage fraud costs the U.S. each year. And it's not just our pockets that are getting picked. Effects from America's financial meltdown have rippled around the world, spreading pain at the speed of the Internet and turning the Great Recession into a global event.

Let's start with a couple of definitions. Residential mortgage fraud is of two types. A government analysis of suspicious activities reported by financial institutions during 2008 revealed that 65 percent of suspected home purchase fraud and 54 percent of suspected refinance fraud was "for housing," meaning that borrowers intended to live in the home and keep payments current. Purchasers were knowingly involved in 87 percent of these suspected frauds, usually by misrepresenting their income and liabilities and offering false documentation. Fudging was facilitated by the widespread use of stated income loans. More popularly called liar's loans, they carried high (subprime) rates but didn't require proof of income.

Mortgage industry workers can increase their sales volume, thus their income by inflating the creditworthiness of marginal borrowers. Indeed, it's estimated that 63 percent of suspected "for housing" schemes involved brokers, and 23 percent appraisers. Indeed, when the market was hot financial firms pressed employees to make as many loans as possible. A State's attorney who investigated the Ameriquest scandal put it succinctly: "The culture was to sell, sell, sell and do whatever it takes to sell, sell, sell." A person who identified himself as a loan underwriter (verifies that loans conform to policy) posted this revealing comment on an Internet bulletin board:

> Now...the initial [loan] application...was submitted [by the loan officer] as [an] unsigned telephone interview so that the gory REAL details of the borrower's data could be swept under the rug and compel the underwriter to approve the loan....I am an underwriter and caught this numerous times to the dismay of my employers who wanted every loan approved. I was not their favorite underwriter...I caught on to the malfeasance...not appreciated. Did this happen on a regular basis, you betcha...every day.

Wait a minute: why would a lender carelessly dole out cash? We'll get to that in a moment. For now let's turn to the other kind of mortgage fraud, "for profit." There are many varieties (for an overview click here and go to page 13.) One of the most popular is "flipping," the repetitive purchase and resale of a home by corrupt investors. It often starts with a desperate homeowner. Inflating the home's value through an exaggerated appraisal (see photo above), fraudsters get the seller to kick back the difference between the loan and the secretly agreed-to purchase price. Using straw buyers, they then "flip" the property through a series of sham resales, at each step profiting from the income generated by ever-larger appraisals. Eventually the property is abandoned to foreclosure or sold to an unsuspecting mark. (Click here for a recent example.)

Builders are often involved in mortgage scams. With a purchaser's assent they may inflate the selling price and apply the excess loan amount as a pretend down payment, thus creating the illusion that a borrower has equity. Many buyers consider this a quasi-legitimate way to acquire a home with no real money down. Of course, if they default the lender will quickly discover that a good chunk of the home's "value" has vaporized.

Reports filed with the Treasury Department suggest that 61 percent of borrowers are knowingly involved in "for profit" schemes. That's second only to brokers (62 percent) and far more frequent than appraisers (23 percent).

When real estate was hot the mortgage industry was more than happy to qualify the unqualified and look the other way as shady brokers and appraisers artifactually increased the value of already overpriced property. In an overheated, go-go atmosphere, with home prices rising before lunch, everyone was eager to play along.

It's not that the Feds didn't realize what was going on. As early as 2004 the FBI's top criminal investigator warned that mortgage fraud "has the potential to be an epidemic." One year later FBI's Mortgage Fraud Report pointed out that "combating significant fraud in this area is a priority, because mortgage lending and the housing market have a significant overall effect on the nation's economy."

And it's not that they lacked legal tools. Mortgage applicants complete a standard form that warns false statements are crimes. Thanks to the interstate commerce clause and the government's insuring of financial institutions and backing of loans, virtually every shady move is a violation of Federal law. Among the applicable statutes are 18 USC 1341, mail fraud; 18 USC 1343, wire fraud; and 18 USC 1014, false statements in loans and credit applications (click here for an example of a charging document in a Federal prosecution.)

Yet as the real-estate bubble grew the number of investigators overseeing the loan industry fell sharply. In the wake of 9/11 the FBI reassigned 2,400 agents from criminal duties to chasing Al Qaeda; by 2007, as the bubble was set to pop, a mere 100 agents were working mortgage fraud. As a retired supervisor said, “we knew that the mortgage-brokerage industry was corrupt....But the agents with the expertise had been diverted to counterterrorism.”

Once the nation started slipping into recession the FBI had second thoughts. Many agents were brought back to fight white-collar crime. Their return was welcome. Naturally, much of the damage was already done.

Really, mortgage shenanigans were the worst-kept secret in the financial industry. Why did lenders encourage unqualified borrowers to sign on the dotted line? Why didn’t they challenge exaggerated appraisals? Because when times were good churning out loans regardless of quality paid rich dividends. Risk was passed along. Mortgages – including the many stinkers – were sold by smaller lenders to the larger, then bundled by the latter into securities that were peddled throughout the world. As long as homeowners paid their debts, investors got their dividends. If a few borrowers defaulted it hardly mattered.

Except that when the bubble burst the cash stopped flowing, *fast*. Firms that had purchased highly-rated mortgage-backed securities (yes, the ratings agencies were in on it too) turned on the Wall Street firms that got them into the fix. In the end Uncle Sam decided that some financial houses were “too big to fail” and propped them up with taxpayer cash. Soon the big fish were again making money hand over fist and vacationing in the Hamptons. (Click here for an entertaining slide show that tracks the mortgage debacle.)

Dreams of home ownership and, yes, profit led many upwardly mobile members of the middle class to take out subprime loans and buy homes that were well beyond their means. Encouraged by brokers and loan officers, ordinary individuals gambled that rising prices would give them enough equity to refinance before teaser rates expired. Holding their noses, they exaggerated their income, minimized their liabilities and dove in. Then the economy collapsed, taking home values with it. Unemployment soared. But like ticking time-bombs the mortgages were still there, their interest rates resetting to stratospheric highs. Without equity getting a new loan was impossible. Jobless or underemployed, owing far more than their properties were worth, millions walked away or were driven from their homes. Once-manicured neighborhoods fell to blight, becoming breeding grounds for crime and disorder.

There's plenty of blame to go around. By all means, point the finger at greedy lenders who peddled loans for which a schnauzer could have qualified. Lock up the crooks who took advantage of the wild-west atmosphere to line their pockets. Go after the financial giants who ignored warning signs and recklessly marketed mortgage-based securities for the sake of a buck. But don't forget that it couldn't have happened without help from the many borrowers who decided that the time was ripe to get theirs, and that if all it took was a few white lies and a little bit of imagination, why that was perfectly acceptable.

After all, things could only go up!