Graphic by Darren Gygi.

The Epidemic of Residential Mortgage Fraud

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Mortgage fraud consists of dishonest conduct, engaged in by a borrower or another person prior to the funding of a loan, that impairs the value of the loan.

This crime has exploded during the past decade, and reports to the federal government of suspected fraud have risen by a magnitude of more than 20 times from 2000 to 2010.

Between 2000 and 2007, mortgage fraud was a key contributor to the unprecedented growth of toxic mortgage assets, which led to the implosion of the subprime lending market.

One might think the collapse of the U.S. housing bubble, with falling housing prices and the tightening of mortgage loan underwriting standards since 2007, would result in a significant reduction in the amount of fraud; but this has not happened.

In fact, the distress in the U.S. housing sales market has proven to be fertile ground for mortgage fraud, with reported incidents of fraud continuing to rise notwithstanding the overall decline in the number of sales of residences and new mortgage loans.

New market conditions have led some perpetrators of fraud to develop new schemes and to modify older ones, and reported mortgage fraud increased 7 percent from 2008 to 2009.

Mortgage fraud is presently the number one white-collar crime in the United States, with the losses for 2009 estimated to be in the range of $15 to $25 billion.

Mortgage Fraud Schemes

The Federal Bureau of Investigation defines mortgage fraud as "the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan."

Mortgage fraud resembles predatory lending in that both refer to tainted residential mortgage loans, but with predatory lending the wrongdoer and victim are switched. Predatory lending refers to improper behavior by the lender or by persons acting for the lender that results in a loan with terms that victimize the borrower with unfavorable loan terms.

Nevertheless, the two phenomena tend to occur in the same geographical communities, which are experiencing a lack of neighborhood stability due to factors such as high rates of market sales, high foreclosure rates and high vacancy rates.

Mortgage fraud consists of two main types – "fraud for property" and "fraud for profit."

Fraud for property occurs when a loan applicant intentionally overstates his income or misrepresents other relevant facts for the purpose of purchasing a property to occupy as a residence. Usually this scheme involves the purchase of a single property, with the borrower taking possession at closing and intending to make regular monthly payments thereafter.

Often, fraud for property goes undetected for a long time period. If the borrower never defaults, the lender does not incur an actual loss, and it is highly probable that the borrower's fraud will never surface.

Fraud for profit refers to a more complicated scheme in which the fraudster's purpose is to cause a lender to make a loan and then escape with the money. The idea is "take the money and run."

Often fraud for profit involves multiple transactions and the use of one or more "industry insider" intermediaries, such as a corrupt mortgage broker, real estate appraiser or settlement agent. Identity theft is frequently one ingredient in this type of wrongdoing.

Fraud for profit accounts for a high percentage of mortgage fraud losses. Data collected by the FBI reveals that "80 percent of all reported fraud losses involve collaboration or collusion by industry insiders."

Flipping is a common fraud-for-profit technique. It occurs when a property is sold multiple times between fake sellers and buyers at inflated prices to create the illusion of a market value drastically higher than the property's real value.

For example, a house worth $180,000 may be sold several times during a two-year period "on paper," with the last sale displaying a price of $400,000. Immediately after the last sale, which is financed by an unsuspecting lender, the seller absconds with the loan proceeds. Foreclosure results, causing a large loss – more than the usual loss stemming from a distressed sale – because even with normal marketing, the property is worth far less than the value asserted in the appraisal submitted to the lender.

Geographical Distance

Today, the typical relationship between a mortgage borrower and lender is characterized by geographical distance. This market characteristic began to develop during the 1970s and replaced "geographical proximity," meaning the parties were situated in the community where the home was located.

During the Great Depression of the 1930s, the federal government adopted reforms that radically transformed monetary policy, the banking system and the operation of credit markets.

The federal reforms had two major consequences for mortgage markets. First, the Federal Housing Administration, and later the Veterans Administration, insured long-term loans (20 to 30 years) with much smaller requirements for down payments than previously required by private lenders. Interest rates were fixed for the loan duration, with monthly payments fully amortizing the loan principal.

A second consequence was the development of national, standardized terms and documentation, which originating lenders had to use to qualify for the FHA and VA programs.

Under the FHA and VA programs, the mortgage lenders who participated chiefly made loans in the local markets where they had a "bricks and mortar" presence.

Geographical proximity between lenders and borrowers was epitomized by the lending operations of the Bailey Building & Loan Association in the classic Jimmy Stewart movie, "It's a Wonderful Life," released in 1947.

This locally owned institution took deposits from residents of Bedford Falls, which it recycled as capital by making home loans to other Bedford Falls residents. Saving, lending and borrowing were all geographically localized transactions.

Locally based home lending, engendering close proximity between borrowers and residential mortgage lenders, began to wane during the late 1970s.

Early the next decade, the federal government deregulated savings and loan associations, the backbone of home lending, allowing them to compete with financial institutions who offered newer financial products to customers.

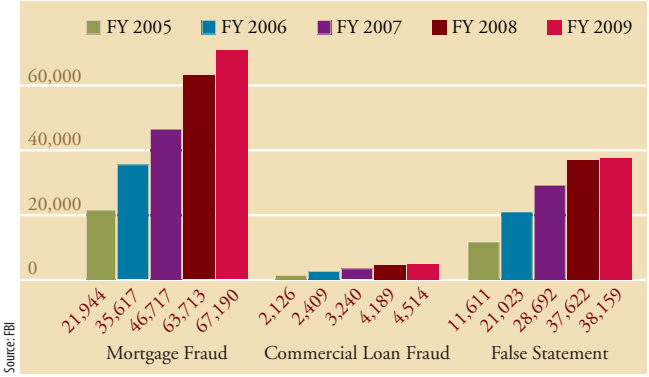
At the same point in time, the secondary mortgage market emerged, which allowed widespread sales of home mortgages through pooling and securitization. Gradually lenders sold more and more of the home mortgages they originated through the secondary mortgage market channels, so that by the 1990s it was rare for lenders to eschew that market by keeping mortgages in their own portfolios.

Local mortgage loan origination followed by immediate sales in the secondary mortgage market creates geographical distance between borrowers and lenders. Although the local originating institution may retain the role of servicing the loan, the real owner or owners of the loan (usually institutional investors) are located in other communities, states and nations.

Another market change created further distance between the lender and borrower. Today, an increasing number of borrowers obtain their mortgage from out-of-town originators. From the standpoint of many borrowers, doing business with a local lender is not a priority. The main point is to obtain the required mortgage money at the best terms (cheapest cost) possible.

Number of Violations of Mortgage Related Fraud

Suspicious Activity Reports FY 2005-09



Source: FBI

> "The lack of fungibility of housing values is a key ingredient that allows many types of mortgage fraud to succeed."

A borrower may deal with a mortgage broker, who has access to multiple foreign lenders; or a borrower may shop for a mortgage loan directly, typically obtaining information and submitting applications through the Internet.

The geographical distance created between lenders and borrowers has substantially increased mortgage fraud risks for lenders (including the ultimate purchasers of mortgage loans) for two reasons.

First, today's lender (or loan buyer) typically has had no direct contact with the borrower and has no personal information about the borrower. Unlike loans made by Bailey Building & Loan, where George Bailey personally knew his customers, today's lender only possesses a name, a social security number and a record prepared by third parties, such as credit reporting agencies and appraisers.

Second, today's lender typically has no direct, personal knowledge about the collateral for the loan, i.e., the house. With loans made by Bailey Building & Loan, the principals and employees of the local lender knew their hometown, Bedford Falls, and all the neighborhoods in which its customers bought homes.

The lack of fungibility of housing values is a key ingredient that allows many types of mortgage fraud to succeed.

A lender's risk with respect to collateral value is reduced if the collateral is one or more units of a standardized type of property, which has a value that is readily determined by reference to published market data.

For example, a secured loan collateralized by assets such as gold (or other standardized commodities) or publicly traded securities presents no real problem in assessing the market value of the collateral at loan origination or on any other given date.

Similarly, determining the value of a typical automobile for the purpose of making a car loan is not overly challenging, given published guides listing estimated dealer and retail prices based on standard variables such as mileage, accessories and general condition.

In contrast, it is much harder to determine the value of any particular dwelling unit, especially when the lender is at a distance. This is why tainted appraisals are readily accepted by originating lenders and by loan purchasers.

Consider, for example, one single-family house, located in Atlanta, Ga., having four bedrooms and two baths. Unless we acquire more information, it is impossible to say what it may be worth. Location and many other variables will determine that house's actual market value.

Transactional Distance

Parties to the traditional mortgage loan once had "transactional proximity," meaning the borrower and lender dealt with one another directly with respect to the loan application and most of the other requirements that had to be satisfied before the lender funded the loan.

When necessary, the principals hired agents, but their roles were circumscribed and their presence did not have the effect of taking control of the transaction away from the principals or reducing direct contact between the principals with respect to the key elements of the contemplated loan transaction.

The secondary mortgage market began taking off during the late 1970s and early 1980s, while the roles of third parties in mortgage loan origination were also changing. Over time, these intermediaries assumed new or expanded roles in facilitating residential loans.

Transactional distance between the borrower and the lender soon became the new norm. Today, most lenders and borrowers have little direct contact as intermediaries separate and isolate the principal parties.

These intermediaries, who sometimes serve as agents for one or both of the parties and sometimes serve as non-agent middlemen, include mortgage brokers, appraisers, closing officers, title insurers, surveyors, credit reporting agencies and participants in the secondary mortgage market.

Mortgage brokers function to eliminate direct contact between lenders and buyers. Not only does the mortgage broker select the lender, or select a small list of prospective lenders for the borrower to consider, but the broker typically serves as the conduit for all communication between the borrower and lender until the closing of the loan.

Real estate appraisers perform the vital role of certifying as to the market value of the house, which serves as the collateral for the mortgage loan.

In relatively few cases, the borrower selects the appraiser. Usually the originating lender picks the appraiser, and today the appraiser is usually an intermediary rather than an "in house appraiser" (an employee of the lender).

In principle, the appraiser's duty to his principal (the lender) should protect the lender from overestimating the value of the collateral.

To the extent that the appraiser must exercise judgment in reaching a professional opinion as to value, the appraiser should estimate a conservative value, to assist the lender in making sure that adequate collateral value will back the loan.

Ironically, however, the proximity between appraiser and lender has generally failed to serve this purpose in modern transactions.

Originating lenders make profits only if they originate loans. They must originate high volumes of loans to obtain significant profits.

During most of the past decade, lenders applied an increasing amount of pressure on appraisers "to hit or exceed a predetermined value." Appraisers who failed to deliver sufficiently high appraisals often lost business, with lenders shifting their business to appraisers who would confirm the target values.

Closing practices have also evolved in the direction of transactional distance. Closings were often held at the savings and loan association or bank building, and even when closings were held elsewhere, such as at a title company, an employee of the lender often attended.

This gave the lender direct control over the closing and the ability to approve all documentation and to deal with any last-minute changes or complications before parting with control over the loan funds.

Nowadays, the norm is for an intermediary to close the loan, acting pursuant to loan instructions issued by the lender. The intermediary is usually a title company employee, an attorney or an independent closing officer.

Most lenders have their loans closed by many different individuals and, as a consequence, the lender usually cannot acquire sufficient information to ascertain the quality of a particular individual who closes its loans.

The pervasive use of all of the intermediaries or middlemen who create transactional distance between borrowers and lenders substantially adds to lender risk.

Not only are borrowers and lenders separated, but the lender relies substantially on the work product of persons with whom the lender generally has no significant prior and continuing long-term relationship, and the lender has no objective reason to believe the work is competent and meets professional standards for quality.

The presence of many intermediaries in today's transactions enables mortgage fraud because fraudsters are able to corrupt intermediaries in a sizeable number of transactions. Even when an intermediary is not induced to prepare a record that he knows to be false, a fraudster can exploit an intermediary – especially one whose level of competence is minimal – by providing the intermediary with false information, which the intermediary turns into a record that appears to be fine on its face.

Financial Distance

Parties to the traditional mortgage loan once had "financial proximity," meaning that the borrower and lender had significant financial interests in the mortgage loan transaction. Both had and kept "skin in the game." Both had significant financial interests after loan funding, which persisted until repayment of the loan at maturity or by refinancing.

Lenders generally required the borrower to make a meaningful down payment; thus, the borrower had an equity stake from day one. The borrower's equity gradually grew every month because loan payments were set at an amount high enough to amortize the loan principal.

By funding the loan, the originating lender acquired a substantial financial asset. Prior to the development of the secondary mortgage market, most originating lenders held the large majority of the loans they made in their own portfolios.

Today, there are still many residential borrowers who have substantial equity in their properties, but there are enormous numbers of borrowers who have no equity (or negative equity) in their homes.

Lenders began offering mortgage products with extremely small down payment requirements – for example, conventional loans with a 3 percent down payment.

More recently, 100 percent financing and mortgage loans that allowed the borrower to finance closing costs by adding them to the initial principal balance became common.

In addition, many newer loan products depart from the norm of level amortization over the loan period. Interest-only loans, which result in no amortization, and negative amortization loans, in which payments during the first years of the loan were less than the accrued interest, became increasingly popular.

During the past two decades, many lenders and borrowers, as well as purchasers of mortgaged-backed securities, ignoring history, have acted as if appreciation in home values is guaranteed and always will have an upward slope to some degree.

Beginning in 2008, the U.S. housing bubble burst, with substantial losses in housing values in virtually every community in the nation. In the aggregate, U.S. homeowners lost close to $8 trillion of housing equity between the high-water mark for housing prices, at the end of 2006, and the end of the first quarter of 2009.

Many owners who in fact had made significant down payments when they bought homes found themselves with negative equity. Such loans are said to be "underwater." As of March 2009, 26 percent of homeowners with mortgage debt owed more than the current value of their homes.

The Problem of Securitization

From the lender's perspective, a key change involves the identity of the real stakeholder and, perhaps more importantly, the manner in which the investment is held.

Due to the securitization of loans through the secondary mortgage market, few originating lenders retain a stake in the loans they create. Instead, originators generate new capital through securitization, selling their loans in the secondary mortgage market.

A prime value of mortgage securitization is that from the investor's perspective, risk is diluted. Rather than owning entire loans, an investor owns a beneficial interest in a pool containing many loans, usually thousands. This hedges risk: A default by any one borrower under any one loan has a small impact on the value of the investor's interest.

However, this raises a tragedy of the commons problem. Although dilution of the percentage of beneficial ownership has the benefit of hedging risk, at the same time it inevitably reduces the incentive that an owning investor has with respect to monitoring the performance of any single loan and, if the loan becomes nonperforming, to intervening to attempt to rectify the situation.

Furthermore, when there is a default in a mortgage in a pool, the investor relies solely upon the efforts of the loan servicing firm and the issuer of the security. These firms lack sufficient incentives to attempt to restructure nonperforming loans.

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Suggested Reforms

Mortgage fraud has flourished because the residential mortgage market has adopted institutions and practices that create distance between borrowers and lenders.

To combat mortgage fraud, reforms should reduce that distance. When it is not feasible to reduce distance, reforms instead should seek to mitigate the risks associated with distance.

With respect to geographical distance, it is neither feasible nor prudent to eliminate or drastically curtail the secondary mortgage market, but other reform measures are possible.

A prime ingredient of mortgage fraud involves deception of the lender as to the borrower's true identity, accomplished through identity theft, straw buyers or other means.

Loan closing practices generally consist of no more than a notary public viewing a borrower's driver's license, typically coupled with the borrower's social security number being displayed on a credit report and other loan-related documents.

Better closing procedures for verifying borrower identity could include requiring the borrower's birth certificate, an identity card in addition to a driver's license, copies of utility bills at the borrower's current or previous residence, and taking digital photographs of borrowers and other closing participants.

The market could attach a "premium" to loans made by community lenders to borrowers residing within their discrete geographical market. Such loans bear less of a risk of mortgage fraud and less risk generally.

The "premium" could be reflected by the price paid for such loans in the secondary mortgage market. Such loans might also properly bear a reduced mortgage insurance fee or one commensurate with the reduced risk.

The proposal for attaching a "premium" to community-bank loans made to local borrowers will also serve to reduce transactional distance because such loans will typically not be made through a mortgage broker.

Another reform aimed at transactional distance is recasting the lender-appraiser relationship. Under present practice, the lender usually contracts with an independent appraiser or appraisal firm.

Lenders should be held liable for the work product of lender-hired independent appraisers to the same extent as if they were employees.

This would extend liability to secondary market buyers of loans who incur loss due to overstated appraisals when the appraisal flaw is due to intentional misconduct or negligence. Such a measure would significantly increase the incentive of lenders to monitor appraiser behavior.

The third type of borrower-lender distance, financial distance, represents the misalignment of incentives to perform between the borrower and originating lender. Reforms on both sides of the lending equation seem necessary.

So far, some attention has been given to the borrower side, with underwriting criteria reformed to require some meaningful down payment for virtually all borrowers.

Reforms are needed to give originating lenders a sufficient, immediate interest in how the loans they make perform after sale in the secondary mortgage market.

The federal Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, requires the seller of mortgage-backed securities to retain at least 5 percent of the credit risk. However, the 5 percent risk retention only applies to loans classified by the lender as high risk, making it easy for the lender to avoid the retention requirement.

More importantly, 5 percent is not nearly enough to incentivize a lender not to make and sell "bad loans." Recourse liability should be much greater. If not "full recourse" (100 percent) which is common in commercial lending, at least much more than 5 percent.

One potential weakness of a meaningful recourse rule is that recourse is only as good as the solvency of the guarantor. As the current financial crisis has demonstrated, many U.S. financial institutions lack the cash reserves and capitalization to weather a significant economic slump.

Accordingly, to serve as a meaningful incentive to avoid originating weak loans, coupled with the imposition of recourse liability, there would need to be assets set aside to cover some percentage of the potential liability.

Conclusion

Mortgage fraud is relatively easy to perpetuate and likely will always be present to some extent.

The mortgage lending process, however, can and should be reformed to decrease the occurrence of tainted mortgage loans.