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The Structural Causes of Mortgage Fraud

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THE STRUCTURAL CAUSES OF MORTGAGE FRAUD

James Charles Smith†

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INTRODUCTION

Mortgage fraud consists of a number of different types of behavior, all of which have the common denominator of conduct that has the intent or effect of impairing the value of residential mortgage loans. The past decade has witnessed an explosion of mortgage fraud, with reports to the federal government of suspected criminal behavior rising by a magnitude of over eighteen times from 2000 to 2008.1 Mortgage fraud is presently the number one white collar crime in the United States.2 It is a key contributor to the unprecedented growth of toxic mortgage assets, which led to the implosion of the subprime lending market. The downturn in the domestic market for housing sales during the past two years has perhaps made mortgage fraud more difficult to perpetuate, but recent statistics indicate that mortgage fraud rates have not declined.3 In fact, the distress in the U.S. housing sales market has

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3. The Mortgage Asset Research Institute (MARI) publishes an annual report that analyzes residential mortgage fraud. Its latest report states:
   [R]eported mortgage fraud is more prevalent now than in the heyday of the origination boom . . . . [F]raud incidence is at an all-time high and is comprised of continuing application misrepresentations and multiple verification-oriented issues. Fewer loan originations coupled with increased fraud incidence equals new times of desperation. Industry expertise and technological advancements, when mixed with
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.

Much of the explosive growth in mortgage fraud rates up to 2007 took place in the subprime mortgage market, but since then the locus has changed due to the almost total collapse of subprime lending. Mortgage fraud perpetrators have not gone out of business; rather, they have adapted to the new constricted market which uses tighter underwriting standards. In the current mortgage market, most fraud associated with new loan applications exploits prime loans, including those backed by the Federal Housing Administration (FHA).

In response to the mortgage fraud epidemic, during recent years the federal government and the states have substantially increased the resources devoted to the investigation and prosecution of mortgage fraud.

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4. Id.

5. An FBI report published in 2009 explains: Industry experts concur that there is a strong correlation between increased fraud and distressed real estate markets. The 2008 current housing market, suffering from an increase in inventory, lack of sales, and a high foreclosure rate, provided an attractive environment for mortgage fraud perpetrators who discovered methods to circumvent loopholes and gaps in the mortgage lending market. Lenders, builders, sellers, borrowers, and other market participants employed and modified old schemes such as property flipping, builder-bailouts, seller assistance, short sales, air loans, foreclosure rescues, and identity theft; and adopted new schemes, including reverse mortgage fraud, credit enhancements, condo conversion, loan modifications, pump and pay—each of which are surfaced in response to tighter lending practices.

6. In its latest annual report the Mortgage Asset Research Institute (MARI) discontinued its past practice of analysis of subprime mortgage fraud as a separate category, explaining: “Given the virtual halt in nonconforming lending and the large number of lender closures, an analysis of subprime fraud is no longer applicable.” ELEVENTH PERIODIC MORTGAGE FRAUD CASE REPORT, supra note 3, at 2.

7. See FBI 2008 MORTGAGE FRAUD REPORT, supra note 5, at 13-14.

8. “A recent trend resulting from the collapse of the sub-prime mortgage market has been the migration of originators and borrowers back to FHA-backed mortgages. FHA’s market share has increased from 3 percent in 2006 to more than 30 percent in 2009 . . . .” Id. at 5. This has made FHA loans an attractive target for fraud. See generally id.
Mortgage Fraud

fraud crimes. Previously, aggressive enforcement was not the norm for several reasons, including a tendency for convicted individuals to receive light sentences and a reluctance of lenders to push for prosecution due to a belief that fraud-related losses were a tolerably small fraction of their overall loan portfolios. At the federal level, in 1999 the Federal Bureau of Investigation (FBI) began active investigations of mortgage fraud in various cities across the United States; over the years the FBI has expanded those efforts, most recently by creating the National Mortgage Fraud Team (NMFT) in December 2008 to assist its field offices in identifying “the most egregious mortgage fraud perpetrators, prioritizin[ing] investigative efforts, and providin[ing] information to evaluate resource needs.”

Although there is no single federal statute addressed to mortgage fraud, federal prosecutors can select from a wide variety of existing financial crime statutes, with bank fraud, mail and wire fraud, and money laundering most commonly used. Beginning in 2005 with Georgia, which was experiencing the highest rate of mortgage fraud in the nation, states moved quickly to criminalize mortgage fraud. Today thirteen states have enacted statutes that specifically define and criminalize mortgage fraud, although in other states acts of fraud committed in connection with mortgage lending will often violate other

criminal statutes. Despite these efforts by federal and state law enforcement, fraudulently obtained loans continue to be a major problem for the mortgage markets. Mortgage fraud has proven to be remarkably difficult to eradicate.

This Article explains why mortgage fraud has flourished by focusing on key characteristics of modern mortgage markets. The root causes of mortgage fraud are associated with the core institutional and structural components of mortgage markets, which cut across all types of residential mortgage products, offered both in the subprime and prime mortgage markets. For a number of reasons, over time it has grown more difficult for mortgage lenders and investors who purchase mortgage loans to assess the quality of their investments.

The common thread that links together a number of developments in modern lending practices is distance between the lender (or purchasing investor) and the underlying asset. Once, prior to the development of the secondary mortgage market, residential mortgage lending was marked by proximity. Distance has replaced proximity along three key axes. First, today lenders and borrowers are usually geographically separated. With the rise of national mortgage markets, geographical distance between lender and borrower and between lender and the property is the norm: Most loans are not made by local lending institutions that have buildings and employees in or near the neighborhoods where the mortgaged houses are located.

Second, today there is transactional distance between lenders and borrowers. Instead of meeting, negotiating, and documenting the loan transaction face to face, lenders and borrowers have little or no direct contact. Instead, intermediaries, such as mortgage brokers, appraisers, insurers, and closing officers, separate the principals, resulting in isolation and making it substantially harder for lenders to evaluate their mortgage investments.

Third, the financial incentives that influence the behavior of both borrowers and lenders have become less compatible. Many modern loans are characterized by financial distance. With the mortgage products offered years ago, both borrowers and lenders had significant

16. See infra notes 46-58 and accompanying text.
17. See infra notes 59-67 and accompanying text.
18. See infra notes 66 and accompanying text.
19. See infra Part III.
20. See infra notes 79-93 and accompanying text.
21. See infra Part IV.
long-term financial interests in the mortgage loan transaction. From the outset, the borrower had equity in the property, which generally grew over time because monthly loan payments were set at an amount that amortized the loan principal. Likewise, the lender held the loan in its portfolio and thus had a direct, substantial interest in the borrower’s performance. Under present conditions, many borrowers have no equity (or negative equity) in their homes, either because they obtained one hundred percent financing or because housing values slumped. Moreover, few originating lenders retain a stake in the loans they create; instead, they generate new capital through securitization, selling their loans in the secondary mortgage market.

I. TYPES OF MORTGAGE FRAUD

Mortgage fraud consists of dishonest conduct, engaged in by a borrower or another person prior to the funding of the loan, that impairs the value of the mortgage. The Federal Bureau of Investigation (FBI) 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.” It 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 which results in a loan with terms that victimize the borrower with unfavorable loan terms. Nevertheless, the two

22. See infra notes 97-98 and accompanying text.
23. See infra note 97 and accompanying text.
24. See infra note 98 and accompanying text.
25. See infra notes 99-101 and accompanying text.
26. See infra note 63 and accompanying text.
28. Predatory lending is not defined by a single criminal statute or another authoritative text. Commentators have offered a variety of definitions. E.g., Celeste M. Hammond, Predatory Lending –A Legal Definition and Update, 34 REAL EST. L.J. 176, 178 (2005) (“There is no uniform definition of predatory loans, but all involve costs and terms that raise the cost of borrowing without any benefits.”); Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 TEX. L. REV. 1255, 1260 (2002) (“[P]redatory lending [is] a syndrome of abusive loan terms or practices that involve one or more of the following five problems: (1) loans structured to result in seriously disproportionate net harm to borrowers, (2) harmful rent seeking, (3) loans involving fraud or deceptive practices, (4) other forms of lack of transparency in loans that are not actionable as fraud, and (5) loans that require borrowers to waive meaningful legal redress.”).
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.\textsuperscript{29}

Mortgage fraud consists of two main types, "fraud for property" and "fraud for profit," terms developed by the FBI in connection with its collection of mortgage fraud data.\textsuperscript{30} 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 the scheme involves the purchase of a single property, with the borrower taking possession at closing and intending to make regular monthly payments thereafter. Modern mortgage products, such as low-documentation loans and stated income loans, which were commonly available during the heyday of the subprime market prior to the latter part of 2008, made it much easier for borrowers to engage in fraud for property.\textsuperscript{31} 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.\textsuperscript{32}

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. There are many different variations of fraud for profit that have succeeded. 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,

\textsuperscript{29} Katz, supra note 2, at 67-69, 145-46. Mortgage fraud and predatory lending also have similar negative effects on communities, which includes dramatic increases in the rates of mortgage foreclosure. See Dan Immergluck & Geoff Smith, Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures, at i (March 2004) (unpublished manuscript, on file with the Syracuse Law Review), available at http://www.woodstockinst.org/document/riskybusiness.pdf ("[A]fter controlling for neighborhood demographics and economic conditions, subprime loans lead to foreclosures at twenty or more times the rate that prime loans do.").

\textsuperscript{30} FBI 2008 MORTGAGE FRAUD REPORT, supra note 5, at 2.

\textsuperscript{31} Merle Sharick et al., Mortgage Asset Research Inst., Tenth Periodic Mortgage Fraud Case Report To: The Mortgage Bankers Association 2 (2008), available at http://www.marisolutions.com/pdfs/mba/mortgage-fraud-report-10th.pdf ("Rising real estate values over the past few years . . . led some individual real estate investors to speculate and stretch the truth on applications for multiple properties . . . Credit standards were loosened. More importantly for fraud, documentation requirements were also reduced. There has been a long history of fraud and sour consequences associated with low/reduced/no documentation loans.").

\textsuperscript{32} Also, such fraud for property may not distort the measurement of market values in the same way as fraud for profit, which often attaches false, inflated values to properties.
Identity theft is frequently one ingredient. According to the FBI, fraud for profit accounts for a high percentage of mortgage fraud losses: “80 percent of all reported fraud losses involve collaboration or collusion by industry insiders.”

One fraud for profit technique, flipping, 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. With flipping, sometimes the lender holds a mortgage obligation of a bona fide buyer, who believed that the purported sale immediately prior to his purchase was an indicator of true value. Other times flipping results in a mortgage obligation that is wholly worthless: The buyer is fictitious, or if a real person, the buyer is insolvent or has hidden his true identity. In such a case, no payment is even made on the loan. 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. Other prominent fraud for profit schemes include builder bail-outs, short sales, foreclosure rescues, credit enhancements, air loans, reverse mortgage fraud, equity skimming, and the double sale of loans to secondary mortgage market investors.

Since the FBI began active investigations of mortgage fraud in 1999 it has focused “its efforts on those perpetrated by industry insiders” rather than borrowers. A unit of the Department of Treasury, the Financial Crimes Enforcement Network (FinCEN), collects data through Suspicious Activity Reports (SARs) turned in by federally

33. For this reason, fraud for profit is sometimes referred to as “Industry Insider Fraud.” FBI FINANCIAL CRIMES REPORT 2007, supra note 10.
34. Id.
35. Id.
36. With a ninety-five percent loan, the lender would have advanced $380,000.
37. See generally Michael Braga et al., How Herald-Tribune Identified $10 Billion in Suspicious Flips, HERALD TRIB., July 19, 2009, at A9. A sampling of data from real property records indicated that illegal flipping in Florida exceeded $10 billion during the recent real estate boom. Id. Three experts said that sum significantly underestimated the actual amount of flipping fraud. Id.
38. See FBI 2008 MORTGAGE FRAUD REPORT, supra note 5; see also Carswell & Bachtel, supra note 9, at 350 tbl. 1 (describing common “fraud-for-profit” schemes).
insured financial institutions and other businesses that provide money services.\textsuperscript{40} Federal law requires the filing of a SAR whenever an institution "detects any known or suspected Federal criminal violation . . . committed or attempted against the bank" or if "the bank was used to facilitate a criminal transaction, even though there is no substantial basis for identifying a possible suspect or group of suspects."\textsuperscript{41} SARs cover a multitude of suspicious activities besides loan-related fraud, including money laundering, insider abuse, and any "transaction [that] has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage."\textsuperscript{42} SAR mortgage fraud filings increased thirty-six percent during 2008 compared to 2007.\textsuperscript{43} SARs do not reveal the full extent of the current mortgage fraud problem. Non-federally insured institutions, including independent mortgage bankers and mortgage brokers, are not required to file reports. Although the FBI notes that the "total dollar loss attributed to mortgage fraud is unknown . . . at least 63 percent (1,035) of all pending FBI mortgage fraud investigations during FY [fiscal year] 2008 involved dollar losses totaling more than $1 million."\textsuperscript{44} The Mortgage Asset Research Institute (MARI) estimated the 2008 losses at between $15 and $25 billion.\textsuperscript{45} In addition to direct losses to lenders and investors, communities in which fraud-affected properties are situated incur substantial losses, including depreciation of nearby properties and increased crime.

\section*{II. GEOGRAPHICAL DISTANCE}

\subsection*{A. Transformation of the Residential Mortgage Market}

The mortgage law markets have evolved drastically throughout the United States since the reforms initiated by the federal government in response to the Great Depression of the 1930s. Prior to the federal Depression Era reforms, real estate mortgage lending was heavily local in nature. Near the end of the nineteenth century, individuals including sellers of real estate held a large majority of all mortgages, and most of

\begin{footnotes}
\item[41] 12 C.F.R. § 208.62(c)(3) (2009). This prong of the regulation has a dollar threshold: Reporting is required if the violations aggregate $25,000 or more. \textit{Id.}
\item[42] 12 C.F.R. § 208.62(c)(4)(iii) (2009).
\item[43] FBI 2008 \textit{MORTGAGE FRAUD REPORT}, \textit{supra} note 5, at 2 (63,713 filed during fiscal year, compared to 46,717 filings in fiscal year 2007).
\item[44] \textit{Id.}
\item[45] \textit{ELEVENTH PERIODIC MORTGAGE FRAUD CASE REPORT}, \textit{supra} note 3, at 7.
\end{footnotes}
those individuals were residents of the states where the mortgaged land lay.\textsuperscript{46} During the nineteenth century, institutions gradually began making more mortgage loans for farm and non-farm residential properties. This trend continued during the first decades of the twentieth century. Building and loan associations, mutual savings banks, life insurance companies, and mortgage companies all provided significant quantities of mortgage credit. Building and loans, which were quintessentially local in character,\textsuperscript{47} took on a rising share of the market for individual home mortgages. At the time of the Great Depression, they held approximately one-third of all home mortgages,\textsuperscript{48} and the home mortgage market had evolved to the point where private institutional lenders were the dominant players. Their lending activities were not regulated by or subsidized by the federal government, and state regulation was uneven and generally light.

The residential mortgage system suffered virtually a total collapse during the Great Depression. Its failure was a key contributor to the economic malaise of other industrial and commercial sectors. Unemployed Americans could not make their mortgage payments, leading to massive spikes in foreclosures nationally. Homeowners lost their homes, and the value of the banks' loan portfolios plummeted. Faced with escalating losses and confounded by a liquidity crisis, banks were unable to pay depositors who sought to withdraw their funds. Numerous banks became insolvent and failed.

Early on in the New Deal, the government quickly moved to enact reforms that radically transformed monetary policy, the banking system, and the operation of credit markets. With respect to housing finance, the National Housing Act of 1934\textsuperscript{49} created the Federal Housing Administration (FHA) and authorized it to develop a mortgage insurance program. The program preserved the role of the private institutional lenders as the suppliers of residential mortgage credit, but encouraged those lenders to make credit available by promising to purchase mortgages that went into default. Through the FHA insurance program, lenders received protection for originating long-term loans

\textsuperscript{46} DAN IMMERGLUCK, FORECLOSED: HIGH RISK LENDING, Deregulation, AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET 21-22 (2009) (noting an 1894 study that found seventy-three percent of mortgages were held by individuals including sellers).

\textsuperscript{47} "Building and loans were local institutions, with members all living in the same area and many of them knowing each other. This social and geographic cohesiveness gave them an informational advantage that kept underwriting costs and defaults low." \textit{Id.} at 20.


with relatively small down payments made by borrowers. In 1944, the Veterans Administration (VA) crafted a similar mortgage guarantee program, with some features that were more generous to borrowers, in order to satisfy the housing needs of returning veterans. The VA program soon eclipsed the FHA program in dollar volume, and was primarily responsible for the soaring post-war rate in the percentage of Americans owning those homes.

A consequence of the FHA and VA programs was the development of national, standardized terms and documentation. Previously there was a far amount of diversity in mortgage terms with respect to interest rates, payment schedules, and maturity. Institutional lenders, however, seldom financed more than fifty to sixty percent of the price of a house. During the 1920s, building and loan mortgages had an average period of eleven years until final maturity, and mortgages made by other institutions had substantially shorter maturity periods. The FHA and VA loan programs promoted long-term mortgages (twenty to thirty years) with much smaller requirements for down payments. Interest rates were fixed for the loan duration, with monthly payments fully amortizing the loan principal. Yet these significant innovations, which made homeownership accessible to many more American families, did not create national markets for the origination and holding of mortgage loans. 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. Thus, federal intervention in residential mortgage lending did not transform local lending markets during the initial decades of involvement, from the 1930s until the 1970s. Proximity between lenders and borrowers remained the norm, as it had been before development of the FHA and VA programs.

Geographical proximity between lenders and borrowers was epitomized by the lending operations of Bailey Building & Loan Association in the classic Jimmy Stewart movie, *It's a Wonderful Life*, released in 1947. That locally owned institution took deposits from residents of Bedford Falls, which it recycled as capital by making home

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50. From 1945 to 1956, VA-guaranteed mortgages on one-to-four family residences increased from one percent of all such mortgages to twenty-nine percent. At the same time, the share for FHA-insured mortgages fell from twenty-two percent to sixteen percent, and the share for conventional mortgages fell from seventy-seven percent to fifty-six percent. SAUL B. KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET 33 (1961).

51. IMMERGLUCK, supra note 46, at 26.


53. *IT'S A WONDERFUL LIFE* (Liberty Films 1946).
loans to other Bedford Falls residents. The market in which Bailey operated, known as the primary mortgage market, was heavily localized in nature and remained predominantly so, even after the invention of federal deposit insurance and the FHA and VA home mortgage lending programs. Lenders also operated under a regulatory regime that substantially restricted interstate banking operations. Local institutional lenders had stable access to capital because the federal government limited the interest rates that commercial banks and savings and loans were allowed to pay to depositors. Savers were generally satisfied because their deposits were federally insured and they could not readily invest their money elsewhere on better terms. Mortgage borrowers were also generally content, as mortgage money was usually available to qualified applicants at stable interest rates.

Locally-based home lending, engendering close proximity between borrowers and residential mortgage lenders, lasted until the late 1970s. During the previous postwar decades, major industries other than real estate had steadily shed their localized character, becoming increasingly regional, national, and international in character. The geographical expansion of markets allowed for specialization in the provision of goods and services by capitalizing on new technologies, infrastructure development, and, at the international level, the growing embrace of free trade principles. Real estate lagged behind with respect to market integration, but, in the residential lending sector, that began to change in the 1970s.

During the late 1970s, several key market changes emerged to alter radically the locally-based lending regime. First, regulatory reform coupled with massive inflation, encouraged savers to move billions of dollars out of deposit accounts in savings institutions and banks into money market funds and similar new investment vehicles, which

57. State usury laws limited the amount lenders could charge, although until the late 1970s the usury laws seldom had a significant impact for mainstream transactions because the usury caps were substantially above market rates.
58. See Malloy & Klapow, supra note 55, at 409-10.
59. See id. at 412.
offered much higher interest rates than the traditional regulated accounts. This led to severe capital shortages for traditional lenders, triggering federal regulatory reform in the early 1980s that eased restrictions on lenders and allowing traditional lenders to compete with financial institutions who offered the newer products. At the same point in time, the secondary mortgage market emerged, which allowed the widespread sales of home mortgages through pooling and securitization. The secondary mortgage market largely solved the problem of inadequate capital held by many mortgage lenders. A lender’s deposits do not limit the quantity of mortgage loans it may make if the lender “cashes out” by selling the mortgages it originates. 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 has created further distance between lender and borrower. Under the older system of mortgage lending, prevailing until the 1970s, home borrowers almost always obtained loans from local lenders, i.e., institutions with a physical “bricks and mortar” presence in the community where the house was located. Also, those

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60. See id. at 412-13.


62. In 1938, the federal government created the Federal National Mortgage Association (now called Fannie Mae) to create a market in FHA-insured loans. IMMERGLUCK, supra note 46, at 33. A limited number of secondary mortgage transactions took place between the 1930s and 1970, but the purposes were limited and the volume was never economically significant. See Malloy & Klapow, supra note 55, at 413-16. The other secondary market giant, the Federal Home Loan Mortgage Corporation (Freddie Mac) began in 1970 to acquire and sell loans for Home Loan Bank system members. IMMERGLUCK, supra, note 46, at 35.

63. In 2006, seventy-six percent of all residential loan originations were sold through securitization. The Role of the Secondary Market in Subprime Mortgage Lending: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services, 110th Cong. 107 (2007) [hereinafter Hearings] (statement of Warren Kornfeld, Managing Director, Moody’s Investors Service). Many other residential loans were sold but not securitized.

64. See Malloy & Klapow, supra note 55, at 409-11.
borrowers tended to get loans from institutions where they already did business, such as the savings and loan where they had a passbook account or the bank where they deposited or cashed their paychecks. Today many borrowers still do deal with local lenders (who as indicated above almost always sell the mortgage loan right after origination), but 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, and in today's competitive marketplace for home mortgage money, often an out-of-town source (a "foreign lender") offers the best financial terms. Comparison shopping by borrowers is usually relatively easy at a low cost. 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.

B. Mortgage Fraud Risks Associated with Geographical Distance

In less than forty years, we have witnessed a radical transformation in residential mortgage markets, moving from highly localized markets to highly integrated national and supranational markets. The geographical distance created between lenders and borrowers has substantially increased risks for lenders (including the ultimate purchasers of mortgage loans) for two reasons. The increased risks directly translate into the ability of lenders to be deceived in mortgage fraud transactions. 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 (where they worked, where they lived, their reputations, etc.), today's lender only possesses a name, a social security number, and a record prepared by a third party—i.e., a credit reporting agency—that indicates information that is thought to bear on the ability and inclination of the borrower to repay the mortgage loan. The lender has no individualized information about the borrower, and thus has no basis for

66. See IMMERGLUCK, supra note 46, at 77-78, 83-84.
67. See id.
68. See generally id. at 99-123.
69. See IT'S A WONDERFUL LIFE, supra note 53.
making an individualized assessment about the risk or safety in making the loan. The lender relies solely on records (paper or electronic) that display purportedly accurate information about the borrower.

Second, and perhaps even more important with respect to mortgage fraud risk, today's lender (or loan buyer) 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. It would have been difficult for a loan applicant to defraud Bailey by submitting documentation that indicated, for example, that market value for a Bedford Falls house that was grossly inflated over its true market value. The lack of direct, first-hand information about the collateral presents a high risk profile for two reasons: (1) home lending is non-pledge based, and (2) houses are highly non-fungible in terms of market value.

All secured lending, in which the lender has collateral to back the borrower's promise to repay the loan, is either pledge based or non-pledged based. A pledge consists of the physical transfer of possession of the collateral to the lender, who holds the collateral for the duration of the loan. Pledge-based lending substantially reduces the risk to the lender, including risks associated with fraud by the borrower. By taking possession, the lender becomes certain that the asset in fact exists, and the lender has the opportunity to ascertain whether the asset is of the nature, type, quantity, and quality as represented by the borrower. The lender is also in firm control of the asset, bearing no risk that the borrower will impair its quality by disposing of it, injuring it, or failing to maintain it. In contrast, non-pledge-based lending presents substantial risk to a lender along the lines of verification of the existence of the collateralized asset, its value, and its retention of value. For some secured transactions, the parties may sensibly select either the pledge or non-pledge model. For example, a borrower may secure a loan by pledging valuable jewelry or stock in a traded corporation, or by retaining possession and granting a security interest to the lender in such

70. See IMMERGLUCK, supra note 46, at 84-98.
71. See id.
72. IT'S A WONDERFUL LIFE, supra note 53. This would be true not only for Bailey Park, the affordable housing community developed by George Bailey for the working poor of Bedford Falls, but also other local residential communities, with which the lender's personnel would be personally familiar; and if not, they could readily acquire first-hand information about particular houses in particular neighborhoods. See id.
73. See generally John J. Worley, Possessory Security Interests, in 1A SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE (Peter F. Coogan et al. eds. 2004).
property. By necessity, however, a home mortgage loan cannot be cast as a pledge transaction. The whole purpose of a home loan is to provide a dwelling unit for the family to live in while the long-term mortgage loan is outstanding. Retention of possession by the lender until the borrower repaid the loan would utterly defeat the purpose of the transaction.

The lack of fungibility of housing values is also 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. This is true whether the secured loan is cast as a pledge or a non-pledge transaction. A sizeable proportion of mortgage fraud capitalizes on the fact that it is difficult to determine the value of any particular dwelling unit, especially when the lender is at a distance. To consider why this is the case, consider the following puzzle:

A lender has the choice of making a secured loan, with the following choices as to collateral:

1. Twenty ounces of gold.
2. Five hundred shares of stock in Microsoft Corporation.
3. One 2008 Honda Civic Sedan X; odometer mileage 6,120; excellent condition.
4. One single-family house, 3 bedrooms, 2 baths, located in the City of Los Angeles, California.

For which of these four types of collateral, is there the greatest chance that the lender will overestimate the value of the collateral (or be induced to accept another person’s overestimate)?

The best answer is number 4. The same problem of valuation is posed by a person buying such assets, rather than taking a security interest in such assets. Sight unseen, without further information, how much are you willing to pay for (1) the gold, (2) the Microsoft stock, (3) the Honda Civic, or (4) the Los Angeles house? For the first two, the buyer can determine the proper price by consulting market data for publicly traded stocks and for commodities, which fluctuate continuously. For the Honda Civic, one can consult published automobile price guides, such as Edmonds and Kelly, which give estimated dealer and retail prices based on variables such as mileage, accessories, and overall condition. The Los Angeles house, of course, is
very different. Location and many other variables will determine that house’s actual market value. It could be worth several million dollars or very little. Although one may be able to obtain market data showing the average value of a Los Angeles three-bedroom house, that fact would be virtually worthless as a guide to determining what a person should pay for any given Los Angeles house.74

The point here with respect to mortgage fraud is the high degree of variability in value enables a person to deceive a mortgage lender with respect to the value of the collateral. One of the most common types of mortgage fraud includes the preparation of an appraisal showing a drastically inflated value.75 For example, a house that is worth $200,000 is shown as having a market value of $600,000, inducing a lender to fund a loan for $570,000 (ninety-five percent of appraised value). Consider how much harder it would be to accomplish the same type of mortgage fraud with respect to the Honda Civic described above. The prospective borrower applies for a car loan, submitting an “expert appraisal” issued by a third party, which states that this one-year-old Civic is worth $45,000. The prospective borrower requests a loan for a high percentage of the asserted value. How likely is this ruse to succeed? No institutional car lender in the United States will fund such a loan, even though it holds paperwork that purports to substantiate the borrower’s claimed value.76

III. TRANSACTIONAL DISTANCE

When there was geographical proximity between the typical borrower and residential mortgage lender, there was what I call “transactional proximity.” By this I mean that 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. Often there was significant face-to-face contact

74. Housing prices are nonscalable. A person can use a statistical average (a mean) to guide behavior when the variation is scalable. But when the sample is of units that are nonscalable, one outlier can skew the mean, making it unreliable as a basis for generalization about the population. See NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE 26-34 (2007).

75. FBI 2008 MORTGAGE FRAUD REPORT, supra note 5, at 2 (“Gross misrepresentations concerning appraisals and loan documents are common in fraud for profit schemes and participants are frequently paid for their participation.”).

76. Perhaps I exaggerate. There are many, many car lenders out there, and some do some mighty foolish things from time to time—but my point still stands; a lender who pays minimal attention to details concerning the requested loan (i.e., consideration of the make and model of the automobile that is to secure the loan) cannot be deceived as to value to such an extent.
between the principal parties.\footnote{77} When necessary the principals hired agents, but their roles were circumscribed and their presence did not have the effects 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 localized nature of residential mortgage markets (geographical proximity, discussed above) fits naturally with transactional proximity. Because the parties were residents of the same community, direct contact was easy and convenient. At the same time in the late 1970s and early 1980s that the secondary mortgage market began taking off, the roles of third parties in mortgage loan origination were also changing.\footnote{78} Over time, intermediaries assumed new or expanded roles in facilitating residential loans. Transactional distance between borrower and lender became the new norm.\footnote{79} In a large proportion to modern loan originations, lenders and borrowers have little direct contact. Instead intermediaries separate and isolate the principal parties.\footnote{80} 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, title insurers, surveyors, and closing officers.

The business of mortgage brokerage is not new, but for most of the twentieth century that occupation concerned itself almost exclusively with commercial mortgage lending. Residential mortgage brokerage was virtually unheard of. When a person contracted to buy a home and did not have a particular institution in mind from which to seek a mortgage loan, the real estate broker gladly recommended one or more institutions, which were typically locally situated. After making the recommendation, the real estate broker stepped out of the picture. The buyer made a loan application and dealt directly with the proposed lender.

Residential mortgage brokerage did not begin in the United States until the 1980s, when banking and lending law reform reconfigured the markets, with a philosophy of deregulation allowing substantially more competition among market participants and the creation of new credit products.\footnote{81} Previously mortgage brokers did not have access to


\footnote{78} See Immerglick, supra note 46, at 99-105.

\footnote{79} See generally id.

\footnote{80} See id.

\footnote{81} See Katz, supra note 2, at 89.
wholesale residential credit markets. As of 2006, mortgage brokers arranged for forty-five percent of all U.S. residential mortgage loans.\textsuperscript{82} This represents a remarkable growth in market share. The percentage is even higher for the subprime market, in which mortgage brokers originated seventy-one percent of the loans during 2006.\textsuperscript{83} Mortgage brokers have thrived due to their low overhead compared to “bricks and mortar” lending institutions and their access to wholesale capital markets and pricing discounts.\textsuperscript{84} A broker can obtain a loan approval for a client borrower from a secondary market reseller, including Fannie Mae before selecting an originating lender. Then the broker can compare lenders’ presently quoted rates and select among those quotes based on criteria such as pricing, closing speed, and documentation requirements.\textsuperscript{85} 

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. The discipline of appraisal is not at all new. Professional training and state licensing began in the 1930s.\textsuperscript{86} The basic principles of appraisal have not changed since the beginning movements towards national residential mortgage markets during the middle of the twentieth century. Today each state has an appraiser regulatory agency, which is responsible for certifying and licensing appraisers.\textsuperscript{87} Prior to 1990, there was substantial diversity among the states with respect to their regulation of the qualifications of appraisers and their supervision of appraisers, and some states even lacked a regulatory agency. The

\textsuperscript{82.} Hearings, supra note 63, at 80 n.6.
\textsuperscript{83.} Id. at 69.
\textsuperscript{84.} See IMMERGLUCK, supra note 46, at 77-78.
\textsuperscript{85.} A mortgage banker often performs a similar role as intermediary to a mortgage broker. The difference is that the mortgage banker may use a short-term credit line, known as a warehouse line, to fund the loan prior to its sale on the secondary mortgage market. Upon sale the mortgage banker repays its warehouse lender.
\textsuperscript{87.} Cherokee W. Wooley, Comment, Regulation of Real Estate Appraisers and Appraisals: The Effects of FIRREA, 43 EMORY L.J. 357, 380-81 (1994).
savings and loan crisis of the 1980s was a catalyst leading to reform at the federal level. In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)\(^8\) required that appraisals used in connection with “federally related transactions” be “performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.”\(^8\) FIRREA resulted in the prompt creation of regulatory agencies in the states that lacked them.

For residential loans to be traded on the secondary market, the documentation must include an appraisal by an appraiser who meets the federal guidelines. In relatively few cases does the borrower select the appraiser.\(^9\) 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). The appraiser plays a crucial role in documenting that the property value is sufficient to serve as collateral for the amount of the loan that the lender is requested to make. 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.\(^9\) Originating lenders make profits only if they originate loans; they must originate high volumes of loans to obtain significant profits. If an appraiser delivers an appraisal that is below the contract price agreed to by seller and buyer, the mortgage loan in the requested amount and loan-to-value ratio is not approved, and thus the transaction usually collapses. During most of the past decade, lenders applied an increasing amount of pressure on appraisers “to hit or exceed a predetermined value.”\(^9\) Appraisers who failed to deliver sufficiently high appraisals often lost business, with lenders shifting their business to appraisers who would confirm the target values. This lender behavior is understandable because the large majority of originating


\(^9\) IMMERGGLUCK, supra note 46, at 105.

\(^9\) See KATZ, supra note 2, at 92-97.

\(^9\) IMMERGGLUCK, supra note 46, at 105 (quoting from a petition signed by thousands of appraisers to protest pressure tactics of lenders and brokers).
lenders sell their loans on the secondary mortgage market. This means
that they do not bear an appreciable risk stemming from overinflated
real estate appraisals; instead, the purchasers of mortgage-backed
securities bear that risk.

Mortgage brokers and appraisers are intermediaries who play roles
early on during the life of the loan transaction, prior to closing, when
typically another intermediary generally plays the critical role. Under
older practices, lenders often directly participated in loan closings.
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, such direct lender participation in residential loan closings
happens infrequently.93 Instead, 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 or an attorney; the
intermediary’s identity varies according to local practice. In
communities of any appreciable size, there are a multitude of
independent closing officers who offer closing services for residential
loans. This means that any particular lender will have its 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.

In today’s mortgage market, there are other intermediaries who
may not be immediately obvious. The secondary mortgage market,
through which originating lenders fully divest themselves of ownership
of the mortgage loans that they generate, consumes a high percentage of
the volume of loans. Participants in the secondary mortgage market are
converted into intermediaries. Effectively, the secondary market makes
the originating lender into a mortgage broker, and thus another
intermediary. The only significant way in which an originating lender
differs from other mortgage brokers is that the originating lender does
not know who will turn out to be the real lender when it makes the loan.
The real lender for any given loan will be the person who purchases the
pool of securitized mortgage loans that includes the loan in question.

93. Grant S. Nelson, Dale A. Whitman, Ann M. Burkhart & R. Wilson
Freyermuth, Real Estate Transfer, Finance, and Development 257 (8th ed. 2009)
(most closing agents are attorneys, title insurance company employees, or escrow company
employees).
Issuers of mortgage-backed securities are also intermediaries, who serve further to separate the borrower from the ultimate lender. Fannie Mae and Freddie Mac are issuers for most conforming mortgages. Investment banks primarily issue securities backed by subprime mortgages and other non-conforming mortgages.\textsuperscript{94} Notably, investment banks that issue mortgage-backed securities do not sample loans or properties to verify the facts; they merely accept the paper offered to them by originators.\textsuperscript{95}

Finally, two types of rating agencies play important intermediary roles. First, credit reporting agencies prepare reports showing the credit history of applicants for mortgage loans. The market for consumer credit reporting is dominated by several national firms, and the credit scores they generate and furnish play the critical role of determining whether the borrower will obtain a mortgage loan, and if so, whether the terms will be those prevailing in the prime mortgage market, offered to highly qualified borrowers, or whether the borrower qualifies only for some type of subprime mortgage product. Second, for mortgage loans passing through the secondary mortgage market, rating agencies assess quality of securitized mortgage bonds. Like credit reporting agencies, the market for securitized mortgage rating agencies is dominated by a few national players. A number of analysts have concluded that flaws in the methodologies and practices of rating agencies, leading to severe underestimation of the actual risks posed by mortgaged-backed securities, were key contributors to the subprime market collapse.\textsuperscript{96}

The pervasive use of all 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 no objective reason to believe that their work is competent and meets professional standards for quality. Most of the intermediaries have no long-term stake in the assets they generate. Most of them do not rely on any particular lender for a substantial proportion of their business, and therefore their incentives to produce quality work are weak.

The presence of many intermediaries in the typical transaction

\textsuperscript{94} See Bar-Gill, supra note 77, at 1090-91.
\textsuperscript{95} See Katz, supra note 2, at 152.
enables mortgage fraud because fraudsters are able to corrupt
intermediaries in a sizeable number of transactions. Even when an
intermediary is not corrupted in the sense of being induced to prepare a
record that the intermediary 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.

IV. FINANCIAL DISTANCE

There is a third dimension, in addition to geography and
transactional connectedness, in which borrowers and lenders are more
separated than they were in the past. Once, borrowers and lenders had
interests that aligned more closely. Both had significant financial
interests in the mortgage loan transaction at the outset of the transaction,
and those significant interests continued during the life of the loan, until
the loan was paid off at maturity or refinanced. Under mortgage terms
that were generally available in the past, the borrower started off subject
to the requirement of a meaningful down payment. This created equity
in the property, which generally persisted and increased over time. Under the standard thirty-year self-amortizing loan, monthly loan
payments were set at an amount high enough to amortize the loan
principal. The borrower’s equity gradually grew every month as she
made monthly payments. Such amortization in effect amounted to a
forced savings plan, which augmented the owner’s equity even if the
property did not appreciate in value at all. 97

Likewise, as soon as it funded the loan the originating mortgage
lender had a substantial interest: It had fully performed its commitment
by advancing all of the loan proceeds, and it was relying on the
borrower’s promise to repay in installments, backed by collateral that it
expected was sufficient to protect its investment. Prior to the
development of the secondary mortgage market, most originating
lenders continued to hold the large majority of the loans they made in
their own portfolios. 98 Thus, the lender had a direct, substantial interest
in the borrower’s performance. Its financial stake continued until
retirement of the loan, even though for a performing loan (i.e. one not in
default) the principal balance owed the lender gradually declined over
time as the loan amortized. In summary, with the residential mortgage
loan products offered years ago, both borrowers and lenders had
significant long-term financial interests in the mortgage loan

97. See Malloy & Smith, supra note 54, at 391-93.
98. See Malloy, supra note 61, at 994.
transaction. Both had and kept substantial economic interests in what happened after loan funding.

Today there are still many residential borrowers who have substantial equity in their properties, but for several reasons there are enormous numbers of borrowers who have no equity (or negative equity) in their homes. First, years ago lenders began offering mortgage products with extremely small down payment requirements—for example, conventional loans with a three percent down payment. More recently, one hundred percent financing and mortgage loans that allowed the borrower to finance her closing costs by adding them to the initial principal balance became common. Second, many newer loan products departed 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. A borrower with one or both of these features—little or no down payment, and no or negative amortization—can still develop substantial equity over time if the property appreciates substantially in value. 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 eight trillion dollars 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


100. During the same time period owners took out more adjustable-rate mortgages (ARMs) than before. Although an ARM can provide for amortization of loan principal to the same extent as fixed-rate loans, ARM borrowers tend to select products that minimize monthly payments, thus resulting in negligible or no loan amortization. One new mortgage product, a payment option mortgage, allows the owner the "option" to choose among monthly payments that amortize the loan, that pay interest only, or that pay a lesser sum than accrued interest (i.e., resulting in negative amortization). In California during the late 2000s, a large percentage of new loans were payment option mortgages. KATZ, supra note 2, at 218.

101.

<table>
<thead>
<tr>
<th>Outstanding Home Mortgage Debt</th>
<th>Housing Value</th>
<th>Equity</th>
<th>Debt-to-Value Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>9.854 trillion</td>
<td>22.0 trillion</td>
<td>12.346 trillion</td>
</tr>
<tr>
<td>2009 IQ</td>
<td>10.462 trillion</td>
<td>14.5 trillion</td>
<td>4.038 trillion</td>
</tr>
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</table>
made significant down payments when they bought homes found themselves with negative equity. Such loans are said to be "underwater." As of March 2009, twenty-six percent of homeowners with mortgage debt owed more than the current value of their homes.102

From the lender's perspective, at first glance it might appear that the evolution of the modern market has had little impact on the lender’s economic position. For every mortgage loan that remains outstanding, the lender holds an asset with a present principal balance and a stated interest rate (which may be fixed or variable). That loan appears to have a readily determinable market value, based on its yield, which fluctuates according to changes in market interest rates, at least if the

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See Fed. Reserve, Federal Reserve Statistical Release: Flow of Funds Accounts of the United States (Mar. 11, 2010), http://www.federalreserve.gov/releases/zl/current/accessible/d3.htm. This data includes all houses that are not subject to any mortgage debt. Thus, the average debt-to-value ratio for owners who have mortgages is much higher.

102. Al Yoon, About Half of U.S. Mortgages Seen Underwater by 2011, REUTERS, Aug. 5, 2009, http://www.reuters.com/article/idUSTRE5745JP20090805. At the end of the first quarter of 2009, owners with the following mortgage products owed more than their homes were worth:

<table>
<thead>
<tr>
<th>Percent of owners with debt greater than value</th>
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<tbody>
<tr>
<td>Prime conforming loans</td>
</tr>
<tr>
<td>Prime jumbo loans</td>
</tr>
<tr>
<td>Subprime loans</td>
</tr>
</tbody>
</table>

16%
29%
50%

Id. A study by Deutsche Bank analysts predicted that the housing decline would continue, with the overall number rising to forty-eight percent by the end of the first quarter in 2011, with the following components:

<table>
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<tr>
<th>Percent of owners with debt greater than value</th>
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<tbody>
<tr>
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</tr>
<tr>
<td>Subprime loans</td>
</tr>
</tbody>
</table>

41%
46%
69%

Id.
loan is performing and there is no reason to suppose that default by the particular borrower is imminent.

What is different today, however, is the identity of the lender 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. This of course completely changes the identity of the person who has a reason to care about the borrower’s performance and the value of the house as collateral. If the borrower defaults and a loss ensues, that loss is borne not by the originating lender, but by the purchasing investor or the mortgage insurer, or those two persons in some combination.103

Securitization through the secondary mortgage market also transforms the manner in which the loan is held, with a dramatic impact on the holder’s incentives. A prime value of mortgage securitization is that from the investor’s perspective, risk is diluted. Rather than owing 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. That risk, even if it is a large loan (e.g., $400,000) is shared with other investors who have purchased interests in the mortgage pool. But 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 non-performing, to intervening to attempt to rectify the situation. Even if an investor with a small beneficial interest could overcome problems of geographical distance and the lack of sufficient information with respect to the borrower and the property, the investor almost certainly would not consider it worthwhile to expend significant resources or time.

To test this, simply ask yourself this: If the $400,000 loan mentioned above went into default, would you be more interested in researching and attempting to solve the problem if: (i) you owned the entire loan or (ii) if you owned 0.1% of the loan (effectively a $400 beneficial interest)? This is a classic commons problem. The interest of

103. For some mortgage securitizations, the originating lender contractually assumes some liabilities with respect to the performance of the mortgage loans it generates and sells, but such warranties or promises have little value. Investors rarely make an effort to collect on them.
any one purchaser in a security in a single underlying loan is so diluted that the purchaser has no incentive to act to protect its property rights. Rather, 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. Those firms lack sufficient incentives to attempt to restructure nonperforming loans, as demonstrated by the current mortgage securitization crisis. Appropriately, such securities are now called toxic assets.

One of the reasons they have become toxic is the commons problem: The decentralization of risk results in no lender or investor having a meaningful long-term interest in discrete loans. Financial distance, rather than financial proximity, is now the defining feature of many modern mortgage transactions. Once, borrowers and lenders had compatible long-term financial incentives with respect to the performance of their loans. Today, for many modern loans, that compatibility has disappeared, being replaced by financial distance in which neither borrower nor investor has sufficient incentives.

V. SUGGESTED REFORMS TO MITIGATE THE EFFECTS OF DISTANCE

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.

In connection with each of the core types of distance discussed above—geographical distance, transactional distance, and financial distance—there are changes in lending practices and terms that are worth considering. With respect to geographical distance, it is neither feasible nor prudent to eliminate or drastically curtail the modern secondary mortgage market. Secondary market activities have produced substantial benefits for both borrowers and lenders, primarily by allowing the national flow of mortgage capital to local markets where there is high demand, by enhancing the liquidity of lenders' mortgage assets, and by spreading the risk of mortgage default beyond individual loans and beyond local markets that periodically become subject to higher than normal default and foreclosure rates. Similarly, with respect to loan origination, it is not practical to revert to the old system in which virtually all mortgage loans were entered into as geographically local transactions, made by "bricks and mortar" lenders to borrowers in within their communities. There is great value in allowing mortgage lenders to compete making mortgage loans across
Mortgage Fraud

Two reform measures bearing on geographical distance are, however, worth considering. First, 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 to confirm borrower identity vary to some extent in different communities and states, but they 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. Here additional safeguards may be helpful. Requiring additional documentation to confirm the borrower’s identity may be a useful measure, even though it will to some extent increase cost. Possibilities include requiring the borrower’s birth certificate, a card in addition to a driver’s license, or copies of utility bills at the borrower’s current or previous residence. Also, taking digital photographs of the borrowers who appear at closing may be worth considering.

Second, 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 community lender may know the borrower due to a previous banking relationship, and if not, the nearness makes it easier for the lender to verify the borrower’s identity and other underwriting-related characteristics, such as employment history and history of prior residences. Moreover, the lender’s geographical proximity to the house that serves as collateral makes it less likely that the lender will be deceived as to value. 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 premium, or one commensurate with the reduced risk. For such a pricing system to work, secondary mortgage market actors would have to devise a system for certifying which loans qualify as made by “community lenders” to local borrowers.

Transactional distance increases lending risk by introducing intermediaries between borrowers and lenders, thereby making it more likely that a mortgage lender will act based on misleading or incomplete information. The proposal mentioned above—attaching a premium to community-lender loans made to local borrowers—will also serve to reduce transactional distance because such loans will typically not be made through a mortgage broker.\footnote{104. A mortgage broker typically matches a home borrower to a distant lender,}
recast the lender-appraiser relationship. Inaccurate appraisals that overstate value, either due to fraud, mere exaggeration, or other factors, are a critical component of many mortgage fraud schemes. Under present practice, the lender usually contracts with an independent appraiser or appraisal firm. It appears that many lenders lack the incentive and possibly the ability to monitor appraisal performance rigorously. It may not be practical to require that lenders conduct their own appraisals of the properties they lend against (in effect, that would amount to a requirement that each lender employ at least one professional appraiser), but as an alternative, a legal reform could make lenders 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 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. No changes, however, have served to give originating lenders a sufficient, immediate interest in how the loans they make perform after sale in the secondary mortgage market. In the event of a loss to a loan purchaser stemming from a borrower default, allowing the purchaser full recourse against the originating lender could, under some circumstances, serve as a powerful incentive for the lender not to make and sell "bad loans." In effect, the originating lender would become a guarantor of the purchaser's performance. If the loan is subject to mortgage insurance (either the FHA or VA program or private mortgage insurance), perhaps the insurer should take by subrogation the right of recourse against the originating lender. One potential weakness of a "full recourse" rule is that recourse is only as good as the solvency of the guarantor. As the

although a broker could select and recommend a local lending institution. A certification system for a community bank's local loans could require the noninvolvement of a mortgage broker in the process.


106. FHA loans, however, still allow a down payment as small as 3.5% of the purchase price of the home, with the remaining 96.5% financed by the mortgage loan. Query whether that is enough equity to create a sufficient incentive for borrowers to perform. FHA Home Loans, http://www.fha-home-loans.com (last visited Mar. 29, 2010).
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. 107

107. The earmarked assets could be a separate cash reserve designated for this purpose or another form of collateral.