

PUBLICATION

Here's a Subprime Primer

September 24, 2007

In the last decade, mortgage fraud has exploded, with lenders, title companies, consumers, and neighborhoods all feeling the sting of financial loss. State legislatures and banking regulators have responded, and federal and state prosecutors have investigated and prosecuted fraudsters. Neighborhood groups have taken on the role of activists in recognizing and reporting suspicious activities occurring upon properties purchased by charlatan "investors."

Lenders have been forced to foreclose literally thousands of loans. In the case of loan flip schemes, where property has been overvalued by unscrupulous appraisers, lenders are left to deal with substantial losses while so-called mortgage investors and other conspirators taking part in the fraudulent schemes walk away with substantial profit.

The FBI reports that mortgage fraud is the country's fastest-growing white-collar crime; the Treasury Department's suspicious activity reports were up 35 percent in 2006; and the Internal Revenue Service's mortgage fraud case load appears to double every two years. The FBI has identified two types of mortgage fraud. In the first instance, "fraud for housing," potential borrowers lie on mortgage applications to get into homes they otherwise could not afford.

More damaging, however, is "fraud for profit," where real estate scam artists take advantage of modern underwriting standards with lax review thresholds. Fraud for profit makes up about 80 percent of the total number of reported mortgage fraud cases, according to the FBI. It often involves insiders familiar with the loan origination process, such as mortgage brokers, who can select loan products with minimum underwriting standards, corrupt appraisers willing to overstate the value of properties, loan applicants who are willing to lend their name and credit histories for payment of a fee, and closing agents who keep lenders in the dark about obvious fraudulent transactions.

With the continued downturn in the real estate industry, more loans are landing in the default category, and lenders are uncovering patterns of mortgage fraud. Particularly, the lending community has discovered that subprime loans are central not only to mortgage fraud schemes—but also to potential predatory lending predicated by loan originators. The outlook appears dire for both lenders and the consumer public.

How Did It Happen? How could the mortgage lending community allow fraud to get out of hand? The answer begins with depersonalization of the mortgage process. A contributing factor is the trend of consumers to seek loans from mortgage brokers who have access to multiple loan products from many different mortgage lenders, rather than from their local banks. The National Association of Mortgage Brokers reports that with as many as two-thirds of all mortgage loans originated by mortgage brokers, lenders often become dependent upon local loan brokers to provide accurate, truthful information about a loan applicant's financial condition during the mortgage process.

Further, the trend to use automated lending processes, designed to prohibit discrimination during the lending process, limits the analysis of a potential borrower's financial condition to the credit score and just three criteria: the applicant's income, the appraised value of property that served as collateral for the mortgage, and the ratio between the loan sought and the property value. The perfect atmosphere for a maelstrom of mortgage

fraud was created by limiting the information analyzed and looking to the loan broker for information without any additional verification.

Fast forward to present-day news reports that there is a subprime mortgage crisis that experts predict may result in foreclosures of thousands of family homes. Consumer groups warn that the American family itself is threatened. Is the subprime crisis connected to mortgage fraud? You bet it is.

At the same time that underwriting standards became lax and automated lending procedures became the norm, consumer advocates and legislatures encouraged lenders to increase home-ownership eligibility by creating programs to qualify more low-to-moderate income applicants for mortgage loans.

Some of these loan programs carried higher interest rates, better rebates, and more profit for the mortgage brokers. Keep in mind, it was the duty of the mortgage broker to guide loan applicants to programs for which they would qualify. However, sometimes the mortgage broker was motivated by the commission rather than the best long-term results for the borrower. This practice is called steering and is illegal.

The profit motive, coupled with the desire for economic prosperity, kicked in and the result is that law-abiding citizens opted to take part in the real estate boom that began at the end of the last century. The climate was ripe for scams on both sides of the mortgage process—by unscrupulous con artists seeking to make a fast buck out of the mortgage process and by unscrupulous loan originators who sought a fast commission by moving unsophisticated consumers into high-cost loans they could not afford.

Subprime loan programs with higher-interest rates seemed to be the answer for consumers with blemished or nonexistent credit histories who otherwise could not purchase homes. In the right circumstances, these loan programs were a viable option. Subprime loans, however, were not intended for investment property. But who was to know? Pick a program, submit information about a borrower through electronic means—and voilà—a mortgage loan was created. Fudge applicant information? Why not? After all, who would know? The lender was not checking the validity of the information provided!

Now as fraud is exposed and an unprecedented number of loans—both for homes and for investment properties—are foreclosed, property values are taking hits, overextended consumers face ruin, and sometimes entire neighborhoods begin to take on the look of evacuated war zones.

How Many in Danger?

Just how many loans could be in danger? As many as one in eight of the subprime loans made in 2000 had foreclosed by May 2005, with predictions that almost one in five subprime mortgages that originated from 1998 to 2006 will result in foreclosure, according to information from the Center for Responsible Lending, a nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and eliminating abusive lending practices.

The statistics do not tell the whole story, however. There is no indication of how many subprime loans were originated as part of elaborate loan fraud schemes or whether the loans originated as legitimate residential home loans. To date, there is no study that analyzes the number of subprime loans which originated legitimately versus those which originated in fraud-for-profit schemes.

It is not hard to understand that consumers wanted to get in on the real estate boom or to achieve the American dream of home ownership. But why would real estate professionals, familiar with professional duties and regulatory requirements, join in the scams in such numbers? Simply put—the money that could be made. As property values were artificially inflated due to mortgage flip schemes, the higher prices typically generated higher fees for brokers, lenders, real estate agents, and loan settlement officers, and higher earnings for real

estate investors. Appraisal fraud had the snowball effect of inflating real estate values in real estate multiple listing systems. In turn, the multiple listing systems were then used by legitimate appraisers as comparable values for determining market values for neighborhood properties.

Predatory lending and mortgage fraud by the loan originators could go unnoticed in most regions, as licensing standards were almost nonexistent in many states. Further, there are no national standards for licensing and oversight of mortgage brokers at this time. Some states license mortgage brokerage offices, but not individual loan officers who work in those offices; 24 states have no specific educational or experience requirements for mortgage brokers; and only a few states require criminal background checks on mortgage brokers, making it possible for unethical individuals to move from one mortgage brokerage firm to another.

Thus, a vicious cycle began. The real estate boom, fueled in part by weakened lending standards that sparked excessive demand, drove up prices. When the subprime loans suddenly showed a massive percentage of foreclosure, what did the lending industry find? A growing pattern of the use of exaggerated or fabricated income information associated with subprime loans. Consumer groups claim that such activities are part of the lending industry's efforts to qualify borrowers in the subprime market just to make a profit. Lenders claim they are the victim of mortgage fraud originated by unscrupulous mortgage brokers and loan officers. Mortgage brokers claim they are the victims of greedy and unscrupulous real estate investors who devise complicated schemes to guarantee loan approval for the undeserving, and unfortunately, consumers claim they were had by all.

Is it mortgage fraud or predatory lending that has caused the crisis? Who are the true victims? Who are the villains? It is obviously a complicated issue, with fingers pointed at everyone taking part in the loan transaction. No one can argue that the mortgage industry has been the victim of unprecedented losses due to unscrupulous loan applicants and the actions by insiders in the loan origination process. No one can argue either that thousands of Americans have been the victims of unfair lending practices that may result in the loss of home and hearth. And, no one can argue there are whole neighborhoods that look like war zones. The homes now lie vacant after being purchased for investment, with their value decimated either by fraud, foreclosure, or perhaps a combination of the two.

The bottom line is that you cannot separate the lender's damage stemming from mortgage fraud from the damages that consumers face from predatory lending practices. Both are illegal. Each is damaging to every consumer. There is no quick answer.

Possible solutions include legislative control, perhaps prosecution, or a tightening of loan underwriting standards. One thing is for certain: The perfect storm created by all these conditions has just begun.