MORTGAGE FRAUD AND THE LAW ENFORCEMENT CHALLENGE

August 6, 2007

By KENDALL COFFEY

The national explosion of bad mortgages has already led to 1.2 million foreclosures, and fraud is apparently a frequent culprit. One leading indicator is the influx of bank-generated suspicious activity reports (SARs) which, for mortgage transactions, have skyrocketed from 11,098 in 2002 to 59,229 in 2006. While the FBI estimates that banks alone lost close to a billion dollars due to mortgage fraud this past year, industry sources project that when the losses of lenders such as mortgage and finance companies are added, the totals are closer to four billion dollars. Meanwhile, in Florida, reports of crooked loans increased by 43% from 2005 to 2006, dubiously distinguishing this state as the nation's leading venue for mortgage fraud.

These grim economics are not being ignored by law enforcement. But in contrast to the public outcry over Enron-era accounting scandals that victimized the many in order to enrich the few, corrupt mortgage transactions create far fewer complaining victims, mostly financial institutions. And the core of mortgage fraud – falsifying loan applications to secure loans that would otherwise not be justified – has potentially hundreds of thousands of accomplices ranging from mortgage brokers and realtors to the borrowers themselves. Illustrating the daunting dimensions of the challenge, one study estimates that, with low documentation loans, which require little, if any, proof of income, 60% of the borrowers inflate their income by 50% or more. As a result, any demand for a step-up in law enforcement resources is overwhelmed by the virtually unlimited supply of potential targets. Underscoring the resource limitations, the FBI is reporting 204 mortgage fraud convictions during 2006, roughly one for every 294 new reports of suspected law-breaking. Even if the request of the Mortgage Bankers Association were granted to add 30 new FBI agents and two more prosecutors, this drop would hardly ripple in the ocean-sized bucket of national fraud problems.

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Given the small-scale resources available for a giant-sized problem, prosecutors will necessarily prioritize high impact cases of "fraud for profit," the multi-transaction schemes orchestrated by industry insiders. Illustrating "fraud for profit," a recent indictment in the Southern District of Florida alleges that defendants used a mortgage business to generate hundreds of thousands of dollars in loan closing fees through scams ranging from bogus documents to bogus purchasers. A second category of mortgage fraud is described by the FBI as "fraud for housing." Traditionally, this scenario, reportedly constituting 20% of mortgage fraud, centers upon single unit transactions in which home purchasers misrepresent their credit worthiness to secure the financing needed to close on their home.

While the current focus is on "fraud for profit" rather than "fraud for housing," the recent profusion of failed mortgage loans may require attention to a new category of home buyer fraud -- "fraud for speculation." During the past three years, as many as 50% of South Florida's condominium buyers in Miami's downtown corridor are speculators according to one reported estimate. Plainly, bad loans have proliferated because many purchasers have stretched not only their resources but also the truth about their finances in order to qualify for real estate opportunities envisioning a high return on a quick resale. Some speculating borrowers who were qualifying by falsifying could be exposed through the discovery processes of civil litigation while others may reach law enforcement's attention through the complaints of aggrieved lenders.

Because the limited federal resources will usually focus on organized fraud orchestrated by industry insiders, launching a wider crackdown that includes scenarios such as fraud for speculation may depend upon the extent to which state police agencies and prosecutors become engaged in combating mortgage fraud. One hopeful sign is Florida's newly enacted mortgage fraud statute that establishes a third degree felony (up to 5 years in prison) for single transaction crimes and a second degree felony (up to 15 years) if two or more properties are involved in the scheme. Anchored upon proof of a deliberate intent to falsify, the statute includes language broad enough to include virtually any knowing participant, with culpability for false documents as well as false verbal statements made "in the mortgage lending process." Although this law will only apply to crimes committed after October 1, 2007, it creates enforcement tools for state authorities that, in some respects, could be more effective than those existing under federal laws. And if this important state legislation signals major state participation, the arms of the law may become long enough to deliver broad-ranging enforcement to a wide open fraud problem.