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ARMed and Dangerous: the Crime of Mortgage Fraud and What Congress Must Do to Stop It

Gabriel Zitrin
American University Washington College of Law, gz4181a@student.american.edu

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AN ECONOMY IN CRISIS: WHAT CAN BE DONE?

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ARMed and Dangerous: the Crime of Mortgage Fraud and What Congress Must Do to Stop It

Gabriel Zitrin

On February 18, 2009, President Barack Obama put forth a $75 billion mortgage rescue plan to assist homeowners who have defaulted or are in danger of defaulting on their mortgages.[1] The plan was greeted with outright horror by conservative think-tanks,[2] Republicans in Congress,[3] and any number of people who fall sharply on the other side of the long-running national debate regarding the role of government in assisting those who have fallen upon hard times in the free market system. In his opposition to the plan, CNBC trading analyst Rick Santelli famously went so far as to characterize defaulting homeowners as "losers" during a widely-publicized on-air explosion.[4]

On a different plane, the aggregate microeconomic catastrophes of widespread mortgage defaults have taken on a potent macroeconomic significance in the wake of the economic downturn of 2007. The largely unnoticed rise of mortgage-backed securities over the last twenty years gradually tied the fortunes of more and more private investors to the ability of the individual mortgage-holder to keep his head above water. While now common knowledge, these severe and far-reaching financial consequences are being dealt with at the usual glacial pace of the federal government.

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[1] Phil Mintz, *Obama Sets $75 Billion Mortgage Rescue Plan*, BUSINESSWEEK, Feb. 18, 2009, http://www.businessweek.com/bwdaily/dnflash/content/feb2009/db20090218_5 82414.htm.
[2] *See*, *e.g.*, Matt Kibbe, *Top 10 Reasons to Oppose the Obama Housing Bailout*, FREEDOMWORKS, Feb. 20, 2009, http://www.freedomworks.org/publications/ten-reasons-to-oppose-the-obama-mortgage-bailout.
[3] *See, e.g.*, Walter Alarkon, *Cantor Criticizes Obama Mortgage Aid*, THE HILL, Feb. 16, 2009, http://thehill.com/leading-the-news/cantor-offers-early-criticism-of-obama-mortgage-aid-plan-2009-02-16.html; Rep. Spencer Bachus, *Statement on Housing Bailout, Cram-Down Legislation*, Feb. 26, 2009, http://republicans.financialservices.house.gov/news/PRArticle.aspx?NewsID=323.
[4] Tracy Connor, *The Case Against the Mortgage Bailout: 'We're Rewarding the Losers'*, N.Y. DAILY NEWS, Feb. 20, 2009, http://www.nydailynews.com/money/2009/02/19/2009-02-19_the_case_against_the_mortgage_bailout_we.html.

For some time it was apparent that few in position to enact measures combating the mortgage crisis fully grasped its severity. On April 17, 2007, for example, the Senate Banking Subcommittee on Securities, Insurance and Investment held a hearing on the role of securitization in the sub-prime mortgage crisis. Subcommittee chair Senator Jack Reed (D-RI) sounded sensible enough in recounting the "dramatic increase in home loan delinquencies and foreclosures [and] the closure or sale of over 40 subprime lenders...in recent months."[5]

But had the senator and his staff realized the full extent of the damage already done and the torrent that would follow, the banking industry presumably would not have been represented at this hearing by, among others, Gyan Sinha, Senior Managing Director at Bear Stearns, and David Sherr, Managing Director and Head of Securitized Products at Lehman Brothers. Bear Stearns was sold to JP Morgan for a pittance less than a year later,[6,7] not long before Lehman Brothers filed for the largest bankruptcy in American history, listing $613 billion in debt.[8] Senator Reed apparently did not anticipate these two mammoth institutions joining the ranks of the defunct in the near future, and this hardly represents a lack of foresight on his part, so much as the shocking severity of the downturn.

While advocacy of mortgage securitization reform could fill many pages, this article will not utilize much space discussing it here. Instead, it will simply argue that while the relevant monetary policymakers continue far too slowly in the pursuit of mortgage securities reform, lawmakers whose purview includes the housing sector should use this opportunity to pursue a

[5] *Subprime Mortgage Market Turmoil: Examining the Role of Securitization Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (statement of Sen. Jack Reed (D-RI), subcommittee chair).
[6] Andrew Ross Sorkin, *JP Morgan Pays $2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, http://www.nytimes.com/2008/03/17/business/17bear.html.
[7] Landon Thomas Jr. and Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, http://www.nytimes.com/2008/03/25/business/25bear.html.
[8] Sam Mamudi, *Lehman Folds With Record $613 Billion Debt*, MarketWatch, Sept. 15, 2008, http://www.marketwatch.com/news/story/story.aspx?guid={2FE5AC05-597A-4E71-A2D5-9B9FCC290520}.

two-part strategy of aggressively combating fraud in the terms and sales of individual mortgages and taking bold measures to ensure that not simply embattled mortgage-holders but the victims of fraudulent lending behavior can achieve financial sustainability, even as they keep ownership of their homes.

The Dream of Home Ownership

Home ownership plays a very powerful role in how Americans think of what differentiates our country from the rest of the world. In every corner of the country, Americans continue to speak and think of home ownership as a right earned no less by virtue of American citizenship than those of free speech, due process or a voice in the selection of our leaders.[9] It is long past time for lawmakers to recognize that this uniquely American cultural drive weighs heavily on many prospective homebuyers, and in fact culturally conditions us to overexpose ourselves in purchasing a home.

It should not be believed that this cultural conditioning is so powerful a force as to eliminate a homebuyer's responsibility for his own mental processes when evaluating whether or not he can afford to purchase a particular home. But while there is no denying the role of personal responsibility, it is preposterous to contend that the mortgage industry does not exploit the especially American dream of home ownership, in its marketing strategies and in its overall contributions to the national dialogue, in the quest for the maximum number of borrowers possible, and the riskiest loans at the highest interest rates.

As put so succinctly by journalist Joe Bageant, "[T]he biggest organized racket in the United States rests upon the dream of owning one's own home. Hundreds of legally sanctioned

[9] *See*, *e.g.*, *Possible Responses to Rising Mortgage Foreclosures Before the H. Comm. on Financial Services*, 110th Cong. 110-21 157 (2007) (statement of George P. Miller, Executive Director, American Securitization Forum).

scams operate under this ruse. Our economy depends upon continuous expansion of housing construction and financing of all types."[10] But widespread home ownership is a threefold objective: not only did it push the American economic bubble perilously outward, not only does it feature prominently in our national identity as "one of the most widely shared values in America and an iconic symbol of personal achievement,"[11] but it also has the potential to make a lot of money for people who are good at securing home loans for others.

"[A]s the housing bubble inflated, wholesalers—though hidden from public view—became high-earning superstars. [Sharmen] Lane, a manicurist before joining now-defunct subprime lender New Century Mortgage in 1997, says she brought home $1 million in 2002 and $1.2 million in 2003."[12] Or, as a mortgage broker that Bageant interviewed put it, "Where else could a guy like me, with no education beyond high school, make $66,000 a year working only twelve hours a week?"[13]

The more loans a mortgage broker is able to secure, the more money he makes, regardless of whether he accurately depicts the buyer's ability to pay. This creates an industry-wide incentive to stretch a buyer's purchasing power completely beyond recognition or the bounds of good faith. The end result, as described by Bageant, should surprise no one: "A complex and nasty circle of credit racketeering by the mortgage and banking businesses based upon conditioned consumer stupidity and millions of very shaky credit applications."[14]

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[10] JOE BAGEANT, DEER HUNTING WITH JESUS: DISPATCHES FROM AMERICA'S CLASS WAR 106, (2007).
[11] *Possible Responses to Rising Mortgage Foreclosures*, *supra* note 9.
[12] Mara Der Hovanesian, *Sex, Lies and Subprime Mortgages*, BUSINESSWEEK, Nov. 13, 2008, http://www.businessweek.com/magazine/content/08_47/b4109070638235.htm.
[13] Bageant, *supra* note 10, at 99.
[14] *Id.* at 104.

The Nightmare of Foreclosure

Faced with the first signs of the crisis it would eventually suffer, the mortgage industry itself bravely declined to see a problem. Instead, in a familiar-sounding opus to free-market principles and that same clarion call of home ownership, David Sherr of Lehman Brothers testified before Senator Reed's subcommittee on April 17, 2007, that "[b]ecause none of the participants in the securitization process benefit from foreclosures, the market has evolved, and will continue to evolve, so as to minimize the number of foreclosures."[15]

Just calling this statement "wrong" does not begin to do it justice. Foreclosure activity for the year 2007, during which Sherr offered his prognostication, rose 75% nationwide from its number in 2006, including 238% in California, 456% in Virginia, and 608% in the District of Columbia.[16] In 2008, the increase was an additional 81% over those same 2007 levels.[17]

Consider Sherr's testimony in a different light: not as having been given eight months before the 2007 foreclosure rates became final, but eighteen days *after* the Mortgage Bankers Association, an industry collective of which Lehman Brothers was a member, reported not only that nationwide foreclosure rates had reached a record high, but that the worst of the problem was yet to come.[18]

Three days before that report was released, the Association's Chairman, John Robbins, grudgingly acknowledged in testimony before the corresponding House committee that "Responsible lenders...do not trick borrowers into loans that are unsustainable. And they do not

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[15] *Subprime Mortgage Market Turmoil: Examining the Role of Securitization Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (statement of David Sherr, Managing Director and Global Head of Securitized Products, Lehman Brothers Inc.).
[16] RealtyTrac, *U.S. Foreclosure Activity Increases 75% in 2007* (2008), http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3988&accnt=64847.
[17] RealtyTrac, *Foreclosure Activity Increases 81% in 2008* (2009), http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5681&accnt=64847.
[18] Noelle Knox, *Record Foreclosures Hit Mortgage Lenders*, USA TODAY, Mar. 30, 2007, http://www.usatoday.com/money/economy/housing/2007-03-13-foreclosures_N.htm.

hold out something that is only a mirage of the American Dream. Yet bad loans were made. They were not made responsibly or with the best interest of consumers in mind."[19] Astute readers will note that here Mr. Robbins chose to employ the passive voice to concede that bad loans "were made," as if all by themselves. This trick neatly absolves any individual entity of any responsibility.

It is astonishing that *any* industry representative could really be so oblivious as to what was happening in his own industry in the middle of its extremely rapid unraveling. What economic indicator could Sherr possibly have cited during his testimony in an effort to illustrate just how well things were going in April of 2007?

Careful readers may have already guessed: "If not for the innovation of mortgage securitization, the United States would not have become the nation of homeowners that it is today, with homeownership close to its highest level in our history – almost 70 percent overall."[20]

What did Mr. Robbins have to say on the subject?

> "Homeownership is near its highest level in history – nearly 70 percent overall… As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years."[21]

This coming three days before the Association of which he was Chairman reported that the rate of foreclosures nationwide had hit a new record.

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[19] *Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Market Conditions Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 110th Cong. (2007) (statement of John Robbins, Chairman of the Mortgage Bankers Association).
[20] *Subprime Mortgage Market Turmoil*, *supra* note 15.
[21] *Subprime and Predatory Lending*, *supra* note 19.

Was Robbins cognizant of the findings of this report? In a word, no. "While overall delinquencies rose in the fourth quarter of 2006, assertions that delinquency rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates have remained relatively low with increases over the last year."[22]

Neither the mortgage industry nor Congress can see any correlation between record levels of homeownership and record numbers of foreclosures. In their view, this must all be a spectacular coincidence.

Not everyone in the upper echelons of our nation's economic hierarchy has proven so impossibly dense, at least not after the fact. "The Bush administration took a lot of pride that home ownership had reached historic highs," said former Secretary of the Treasury John Snow, "but what we forgot in the process was that it has to be done in the context of people being able to afford their house. We now realize there was a high cost."[23] It is less certain that men such as Scherr and Robbins arrived at this revelation even in the wake of all that has occurred since their pronouncements.

Truthfully, it serves little purpose to chastise the Bush administration, Congress, or even the mortgage industry for failing to see the nature of the correlation between the dream of home ownership and the nightmare of foreclosure as clearly as did the Joe Bageants of the world.[24] What is critical now is to avoid exacerbating the mistakes of the past by failing to take adequate steps to prevent their repetition in the future.

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[22] *Id*. at 15.
[23] Jo Becker, Sheryl Gay Stolberg, & Stephen Labaton, *Bush Drive for Home Ownership Fueled Housing Bubble*, INT'L HERALD TRIB., Dec. 21, 2008, http://www.iht.com/articles/2008/12/21/business/admin.php.
[24] Indeed, it would likewise be unfair to characterize the Bush administration's drive for home ownership for its own sake as having been a departure from similar policies in the past under both Republican and Democratic presidents. The Bush administration, however, chose to pursue the policy at the tail end of an economic boom, as opposed to the administration of President Bill Clinton, which began to implement its policies during a period of much lower housing prices.

HASP: Taking a Stand Against Mortgage Fraud - Or Not.

A major piece of any plan to protect homeowners from foreclosure must be an emphasis on those homeowners whose applications were in some way fraudulent, though such a determination will most likely only be feasible for future cases. These homeowners have been victimized for chasing the American dream, and it is difficult to imagine their role in the fraud itself as having been anything more than secondary to the professionals who not only know the tricks of the trade that will get a mortgage approved, but also take a tangible profit from the resulting transaction.

In focusing borrower assistance on the victims of mortgage fraud, active victims though they may have been, the federal government would be sending the message that it will not tolerate either the everyday exploitation of the American dream of home ownership or the plainly criminal acts in which that exploitation can take shape.

But President Obama's proposed housing plan, officially the Homeowner Affordability and Stability Plan (HASP), makes no mention of fraud. It therefore treats equally those homeowners who have defaulted or are in danger of defaulting no matter the degree to which their mortgage applications were massaged by their brokers to squeeze through the tight bars of legality, or if the applications were completely legal and honest. An emphasis on the victims of fraud would not only best serve the interests of justice, but would reduce the risk of incentivizing reckless behavior that remains one of HASP's biggest sticking points.[25]

In the absence of any mention of mortgage fraud in HASP, it is anyone's guess how much the administration ever even intended this plan to assist the victims of mortgage fraud, and how much was simply aimed at any and all homeowners who meet its listed criteria. How disappointed can we be at the lack of any such distinction? Absent any official estimation of the

[25] Bachus, *supra* note 3.

prevalence of fraud in the origination of mortgages that wound up in default, the administration has no ability to craft a plan designed to prevent such behavior and its deleterious effect on American families and the economy at large.

Why are the President and Congress, to say nothing of state and local governments, so powerless to repair the damage done by fraudulent mortgages? Because without an institution tasked with this very duty, no government, local, state or federal, has the resources to make the distinction on even the most cursory level between a defaulting buyer whose ability to afford their home was fraudulently overstated, and one who has simply suffered the way so many have in these difficult economic times.

Assessing the Prevalence of Fraudulent Mortgages - Or Not.

Unfortunately, as the reader may have noticed, evidence of mortgage fraud at this juncture is virtually all anecdotal, even if it paints a picture of an epidemic. Neither Joe Bageant, nor BusinessWeek, nor the Chicago Tribune have any way of demonstrating the full extent to which fraudulent mortgages have exposed a vulnerable financial sector, and ruined the finances of American families.

The Mortgage Asset Research Institute's most recent Quarterly Fraud Report estimates that mortgage fraud rose 45% in the second quarter of 2008 from the same period in 2007,[26] but makes no attempt to gauge what portion of the total mortgage market was affected.

Be you a second-year law student or the former Treasury Secretary, a respected business publication, major daily, or intrepid independent journalist, you will find it difficult to expose the evils of mortgage fraud because of a lack of hard evidence about its prevalence, no matter how

[26] Quarterly Fraud Report, 2Q 2008, Mortgage Asset Research Institute, Dec. 2, 2008 http://www.marisolutions.com/pdfs/mba/mortgage-fraud-report-2008Q2.pdf.

powerful and seemingly damning your anecdotal evidence may be, or how much of it can be assembled. For example:

> "Court documents and interviews with scores of industry players suggest that wholesalers also offered bribes to fellow employees, fabricated documents, and coached brokers on how to break the rules. And they weren't alone. Brokers, who work directly with borrowers, altered and shredded documents. Underwriters, the bank employees who actually approve mortgage loans, also skirted boundaries, demanding secret payments from wholesalers to green-light loans they knew to be fraudulent. Some employees who reported misdeeds were harassed or fired."[27]

"We are talking pure lizard sleaze… Dealers falsify down payment information on credit applications, fake the terms and the price, and add on inflated fees from the word go."[28]

"The key is to refinance borrowers whose current loans involved fraud in the origination process. And I assure you it was a minority of borrowers whose loans didn't involve fraud."[29]

"At the crisis' core are loans that were made with virtually nonexistent underwriting standards - no verification of income or assets; little consideration of the applicant's ability to make payments; no down payment."[30]

"A former Wells Fargo wholesaler says he regularly used the copiers at a nearby Kinko's to alter borrowers' pay stubs and bank account statements. He would embellish job titles -- turning a gardener, for instance, into the owner of a landscaping company -- and inflate salaries."[31]

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[27] Der Hovanesian, *supra* note 12.
[28] Bageant, *supra* note 10, at 107.
[29] Sean Olender, *Mortgage Meltdown: Interest Eate 'Freeze' - The Real Story is Fraud*, S.F. CHRON., Dec. 9, 2007, http://www.sfgate.com/cgibin/article.cgi?f=/c/a/2007/12/09/IN5BTNJ2V.DTL&hw=Sean+Olender&sn=007&sc=593.
[30] Stan Liebowitz, *The Real Scandal: How Feds Invited the Mortgage Mess*, N.Y. POST, February 5, 2008, http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm.
[31] Der Hovanesian, *supra* note 12.

"I'd walk into mortgage shops and see brokers openly cutting and pasting income documents and pay stubs, getting out the Wite-Out and changing Social Security numbers."[32]

"A real estate appraiser would appraise the homes at inflated prices, prosecutors said. Then, Navascues would fill out fraudulent loan applications exaggerating the buyer's financial means."[33]

"During the boom, many lenders, including Countrywide, gave borrowers loans without requiring them to document their income. It was widely assumed that many of the borrowers didn't document their incomes because they were lying."[34]

One could go on and on and on, but as long as the mortgage industry is prepared, as they undoubtedly are, to argue that despite such sensational stories, fraud is not a major cause of the foreclosure crisis, and as long as the federal government is making no attempt to find out whether this argument has any merit, we might as well move on.

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[32] *Id*.

[33] David Heinzmann, *Loan Plot Allegations Grow: Bank Sues to Recover Lost Money, Accuses Lincolnwood Firm of Mortgage-fraud Scheme*, CHI. TRIB., Nov. 19, 2006, at C1.

[34] David Streitfeld, *Countrywide Chief Sees 'Opportunity'*, L.A. TIMES, Sept. 19, 2007, at C3.

It is not entirely correct that no one has made an effort to list the various causes of foreclosures. Freddie Mac's 2006 (pre-crisis) analysis of its own portfolio yielded the following[35]:

CHIEF CAUSES OF MORTGAGE DELINQUENCY 2001-2006

Cause	**2001-2005**	**2006***
Unemployment or Loss of Income	42.8%	36.3%
Illness in the Family	19.2%	21.1%
Excessive Obligation	11.1%	13.6%
Marital Difficulties	7.9%	6.0%
Death in the Family	3.7%	3.9%
Property Problems or Casualty Loss	1.7%	2.8%
Extreme Hardship	2.8%	0.9%
Inability To Sell Or Rent Property	1.3%	1.4%
Employment transfer or military service	0.9%	0.6%
All other reasons	8.7%	13.3%

*Excludes delinquent loans in Louisiana and Mississippi due to the effects of the 2005 hurricanes.

Mortgage fraud is not listed here alongside the sorts of causes of foreclosures that have been in the industry's consciousness for much longer. What we have instead is a list of potential causes for delinquency that will *all* be made more likely if the buyer's ability to withstand them has been overstated at the origination of the mortgage (though one may ask whether "excessive obligation" means what it seems to mean, and if not, what they could mean by this term).

[35] Freddie Mac, *2006 Drop in Delinquencies Show Shifting Reasons Behind Single Family Late Payments*, http://www.freddiemac.com/news/archives/servicing/2007/20070425_singlefamily.html.

Countrywide Financial, which was the nation's largest mortgage broker[36] up until its spectacular collapse,[37] released a similar portfolio analysis in September of 2007.[38]

> So what's driving foreclosures? Here is Countrywide's breakdown -- based on information from its servicing portfolio -- when "cause of foreclosure" is known (80.3%), the breakdown is as follows:
> -- Curtailment of income: 58.3%
> -- Illness/Medical: 13.2%
> -- Divorce: 8.4%
> -- Investment Prop./Unable to sell: 6.1%
> -- Low regard for property ownership: 5.5%
> -- Death: 3.6%
> -- Payment adjustment: 1.4%
> -- Other: 3.5%

This may be a different source, but it tells the same story. Fraudulent mortgage applications make delinquencies more likely even though in lists such as these they will be tucked into other categories, because at the moment no one has the wherewithal to give them their own.

Minnesota, California and the Illusion of Action

Efforts to combat mortgage fraud have produced a checkerboard pattern across the states, but the predominant legal condition mirrors the absence of any reference to mortgage fraud in the federal code. New York, Pennsylvania, Ohio and Illinois, for instance, do not yet have provisions to punish mortgage fraud.

Minimal concrete efforts have been made in some states, such as Minnesota and California, that hardly inspire confidence that they will make a huge difference in combating the

[36] Streitfeld, *supra* note 34.
[37] For a general overview of Countrywide's fall, *see* David Ellis, *BofA inks deal to buy Countrywide for $4 billion*, CNNMONEY.COM, Jan. 11, 2008, http://money.cnn.com/2008/01/11/news/companies/boa_countrywide/index.htm.
[38] Peter Viles, *What Causes Foreclosure? Countrywide's Claims*, L.A. TIMES, L.A. Land Blog, Sept. 19, 2007, http://latimesblogs.latimes.com/laland/2007/09/what-causes-for.html.

problem. These efforts are preferable to the complete inaction found elsewhere, but woefully insufficient in the face of today's nationwide mortgage crisis. The Minnesota statute states that:

> (a) No person acting as a residential mortgage originator or servicer, including a person required to be licensed under this chapter, shall… (9) make or cause to be made, directly or indirectly, any false, deceptive, or misleading statement or representation in connection with a residential loan transaction including, without limitation, a false, deceptive, or misleading statement or representation regarding the borrower's ability to qualify for any mortgage product[.][39]

The good news out of Minnesota is that the drafters of this law clearly have a good idea of the form that fraudulent mortgage applications frequently take, and have taken a very simple step to outlaw it. They understand that some foreclosures, even if they don't know exactly how many, are products of the overstatement of the buyers' ability to pay, and by extension, perhaps they even recognize the connection to the exploitation of the American dream of home ownership. The federal government needs to recognize the interconnectedness of these factors, and to enact legislation that reflects this understanding.

Of course, it should stand out immediately that there are no penalties incurred by violating the Minnesota law, except impliedly the loss of one's mortgage broker's license in the state of Minnesota, and even that isn't specified.[40] Given that between 2006 and 2008, the number of properties foreclosed upon in Minnesota rose 336%,[41] the state of Minnesota owes its citizens the protection of criminal and civil penalties attached to this specific statute.

Mortgage fraud is far from the exclusive cause of the 336% increase, but to add penalties to the statute costs nothing, and if they prevent even one further instance of fraud, or properly

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[39] MINN. STAT. § 58.13 (2009).

[40] This is consistent with the rest of the broker's code of conduct that comprises § 58.13. For an example of a similar statute, *see* OR. REV. STAT. § 59.971 (2008).

[41] RealtyTrac, *Foreclosure Activity Increases 81% in 2008*, *supra* note 17.

punish one person for ruining a family's finances, possibly even giving that family a way to recoup their losses, it will have been a good and useful law.

The second problem with the Minnesota statute is that it remains general enough to leave some potential loopholes. For example, the section "regarding the borrower's ability to qualify for any mortgage product" could be made far more specific, and in fact tailored to the information contained in a real mortgage application. The anecdotes of sleazy behavior above provide excellent examples of more specific conduct to be made illegal: the failure to describe a buyer's profession in good faith, the alteration of a payroll document, or keeping oneself deliberately ignorant of a buyer's true financial state. The current language of the Minnesota statute prohibits the making of a deceitful statement, thus not forbidding any of the above examples. These and a great many other underhanded tactics need to be specifically forbidden by law, not to mention penalized.

The protections of this statute are not weak because the Minnesota legislature failed to think of any stronger ones, nor because they had heard no stories from their constituents about the specific methods that certain mortgage brokers have discovered to manipulate the system. Far more likely, they simply see no reason to heighten the specificity or the sanctions of a totally unenforceable statute.

Imagining for a moment that section 58.13 imparted criminal liability, who would realistically be prosecuted for violating it? The actions that it makes unlawful take place well below where the gaze of the state can fall, and an individual dishonest mortgage broker in Minnesota, or anywhere else, can currently victimize and falsify with almost total impunity.

California, the nation's most populous state, positively brutalized by the mortgage meltdown, has language that comes with penalties attached, and yet is probably on the whole even less stringent than the law in Minnesota. The California statute reads:

> A person who originates covered loans shall not make or arrange a covered loan *unless at the time the loan is consummated, the person reasonably believes the consumer, or consumers, when considered collectively in the case of multiple consumers, will be able to make the scheduled payments to repay the obligation* based upon a consideration of their current and expected income, current obligations, employment status, and other financial resources, other than the consumer's equity in the dwelling that secures repayment of the loan. [Emphasis added.][42]

Proving, to the degree required for a criminal conviction or civil liability, that the loan originator lacked such a reasonable belief is an extremely tall order. While there are no readily-available statistics on how many people have been charged with a violation of, or sued under, this statute, it is difficult to imagine the number being very high.

And the penalties attached? A fine of up to $2,500, civil liability to the state capped at $25,000, and civil liability to the victimized party in the amount of actual damages suffered or $15,000, whichever is greater, plus attorneys' fees and costs.[43] How many prosecutors, or plaintiffs' lawyers representing mortgage fraud victims, will look at this statute and conclude that pursuing this matter isn't a complete waste of time? Who can pay their attorneys to pursue this action, having just lost their home to foreclosure? Who, realistically, will take up the challenge of proving a lack of reasonable belief in the hopes of recouping actual damages? A legal remedy so inadvisable to pursue is no remedy at all. Action by a state legislature must provide constituents with a realistically useful recourse to the law. What this statute provides is nothing more than the illusion of action.

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[42] CAL. FIN. CODE § 4793(f)(1) (2009).
[43] CAL. FIN. CODE § 4978(a) (2009).

While a more cynical observer might ascribe sinister motives to the California legislature, such as the desire to grant unscrupulous mortgage brokers the same free license they would enjoy in the absence of any statute at all, it seems logical that the penalties are so weak for the same reason that there are no penalties in Minnesota – as long as the state lacks the resources to investigate the transactions themselves, and as long as a victorious civil suit is so unlikely, giving the statute more teeth would serve no purpose.

Lenient Penalties, Harsh Penalties, and from Washington, Silence

The sad fact is that no matter how stiff a state were to make penalties for mortgage fraud, without a way to enforce them, the statutes serve little purpose. Such penalties do exist: besides California, Oklahoma subjects violators to a fine of up to $1,000, which was hopefully a lot more money when the law was enacted in 1968, and/or imprisonment of up to one year.[44] These penalties are still far below what any victim of mortgage fraud would consider just.

Maryland, in 2008, passed almost unanimously[45] the only state law in the nation that seems to indicate a proper understanding of how severely mortgage fraud should be punished. Violating this law comes with a felony conviction, civil liability for up to three times the damages suffered, and most importantly, up to ten years imprisonment, or more under the aggravating circumstances of a pattern of behavior or the exploitation of a vulnerable adult victim.[46] The definition of what comprises mortgage fraud is also considerably more detailed than it is in Minnesota and elsewhere. But despite the hard stand taken against mortgage fraud, the law doesn't outline how the state will pursue any charges unless the evidence falls from the sky into the lapse of state prosecutors.

[44] OKLA. STAT. ANN. Tit. 21, § 1500 (West 2008).
[45] http://mlis.state.md.us/2008rs/billfile/sb0217.htm.
[46] MD. CODE ANN., REAL PROP. § 7-401 et. seq. (West 2008).

Even with banks more watchful in the wake of the subprime fiasco, no public institution currently audits any meaningful portion of mortgage applications to ensure the well-being of the purchaser, lender, and the state.

To their credit, the Indiana legislature recently created a mortgage lending and fraud prevention task force, staffed by state employees across various departments and regulatory agencies responsible for aggregating the individual agencies' reports, policies and recommendations about mortgage fraud.[47] It is not a huge stretch to see this as an appropriate activity for an agency of the federal government. More appropriate still would be an effort on the part of this same task force to conduct investigations and audit mortgage applications, similar in both purpose and practice to the income tax audits performed by the Internal Revenue Service and other federal tax authorities.

But the current federal efforts to counteract the effects of mortgage fraud are inadequate and halfhearted. The federal government seems as hamstrung as Minnesota and California by the daunting task of enforcing any such measures. It took the federal government until July of 2008 to enact PL 110-289, which requires the reporting of confirmed or suspected fraudulent mortgages on a case-by-case basis.[48]

But the law only applies to mortgages upon their purchase or sale, not at any point during the origination process.[49] In other words, rather than even going so far as to delegate responsibility to the lenders themselves to protect the homebuyers who will be their sources of income, the federal government has thus far apparently decided that such protections are not feasible.

[47] IND. CODE § 4-6-12-2 (2008).
[48] 12 U.S.C.A. § 4642.
[49] *Id.*

Under current federal law, with no complement to § 4642 geared towards the origination process, a lender can lend to a homebuyer with no effort to discover whether the application is dishonestly written, nor indeed any duty to report the application even if they make such a discovery. If, an undetermined time later, the resulting mortgage is sold as part of a security (or individually), there is a duty to report the suspected fraud, but isn't that a little late in the game?

One may recognize in the statute the larger effort to protect the economy from the dangers inherent in mortgage securitization, and this effort is to be applauded, but how does the federal government owe *less* of a duty to the individual purchasers of the exact same fraudulent home loans that must be reported under this law?

Conclusion: Congress Must Take Action

So how prevalent is mortgage fraud across the country? It is time to stop endlessly asking this question and get an answer. Congress must, as soon as possible, take several steps.

First, create, by legislation, an independent agency with regional branch offices tasked with auditing as many home mortgage applications as possible from a wide range of real estate markets to ensure that they accurately reflect the buyer's ability to pay;

Second, fully fund this agency's administrative costs as an investment in the future economic viability of the mortgage industry, investors in mortgage-backed securities, and American families in every state; and

Third, enact stiff criminal and civil penalties for fraud committed during the loan origination process, using Maryland's tough new law as guidance, along with the proposed modifications.

This plan should satisfy even the opponents of government spending and federal bailouts. The administrative costs of such an agency will be miniscule compared to the money saved in the future by both private actors and the federal government by minimizing the economic risks associated with shady mortgage practices. The new oversight will also reduce, and hopefully even eliminate, the necessity for such interference as the administration's $75 billion mortgage rescue plan in the future.

How much exactly will the risks and costs be reduced? No one knows until the agency itself, or one like it, finally makes a fact-based assessment as to the prevalence of fraudulent mortgage applications and their impact on both homeowners and investors. But even the slightest effectiveness, enforcement and deterrence would result in the agency paying for itself almost immediately.

Finally, in anticipation of the tired argument that any form of regulation will make it harder for homebuyers to obtain mortgages by reducing lenders' incentive to grant them,[50] the legislation should be carefully drafted to apply only to cases in which fraud was present in the loan application process. *No* single homeowner will be less likely to obtain a *non-fraudulent* home loan under this plan. As for the decreased availability of inadvisable home loans obtained with the aid of unscrupulous estimations of the buyer's ability to meet their financial obligations, the mortgage market will likely survive the hit. Even the most fervent self-described champion of the free market is unlikely to defend a homeowner's "right" to be victimized in such a way.

This legislation will cost the taxpayer very little, save the government from having to bail out banks and individual citizens, save American homeowners from financial ruin, and impose upon no one but those engaged in criminal activity. The consequences of not adopting these

[50] *See, e.g.*, Brief for Competitive Enterprise Institute et al. as Amici Curiae Supporting Respondents 16, Watters v. Wachovia Bank, 550 U.S. 1 (2007), and Bachus, *supra* note 3.

protections have been financially devastating to homeowners, investors, the federal government and the economy as a whole. It is time for Congress to correct a wide array of wrongs.

Afterword: What Real Action Looks Like

It should not come as a great surprise that someone else came up with the idea of federal civil and criminal liability for mortgage fraud long before me. Bill S. 1222 of the 110th Congress, a duplicate of the sponsor's identical bill of the previous year, was introduced in the United States Senate on April 25, 2007.[51] Aptly named the STOP FRAUD Act, it is by far the most ambitious plan to combat mortgage fraud that has come out of the federal government, including new grant programs for state and local law enforcement agencies,[52] $25 million for housing counseling,[53] and the creation of mortgage fraud as an affirmative defense in a foreclosure proceeding.[54] Its sponsor showed an uncommon awareness of the mortgage fraud epidemic in calling for support for the bill.

> "Mortgage fraud and abuse are growing problems in this country, problems that are depriving thousands of Americans of their dream of homeownership and often their hard-earned life savings… Although the data in this area is limited,[55] mortgage fraud, which takes a variety of forms from inflated appraisals to the use of straw buyers, is a growing problem. In September of 2002, the FBI had 436 mortgage fraud investigations. Currently, they have more than 1,036."[56]

And he refreshingly backs up that understanding with a solid definition of mortgage fraud, and the political will to use federal law to outlaw it.

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[51] 110 Cong. Rec. S5086 (daily ed. Apr. 25, 2007).
[52] STOP FRAUD Act, S. 1222, 110th Cong. § 8 (2007).
[53] *Id*. at § 6.
[54] *Id*. at § 10(a)(2).
[55] How little hard data is there on the prevalence of mortgage fraud? The absence of any in the Senator's floor statement strongly suggests that he and his staff couldn't find any more on the subject than I could.
[56] 110th Cong. Rec., *supra* note 51 at S5106.

> "(a) In General- It shall be unlawful for any mortgage professional to knowingly execute, or attempt to execute, a scheme or artifice --
> (1) to defraud any natural person, financial institution, or purchaser of consumer credit or an interest in consumer credit in connection with the offer or extension of consumer credit."[57]

This language should have been added to the United States Code a long time ago. Simple, and in retrospect blindingly obvious, the biggest problem with implementing it now would be that we have already suffered a hefty chunk of the consequences of having lacked it during "the halcyon days of mortgage fraud from 2004 to 2006."[58] But hindsight is so often the driving force behind legislation of all types.

But it's the next section that should *really* raise some eyebrows.

> (b) Penalties-
> (1) CRIMINAL PENALTIES- Any mortgage professional who violates subsection (a) shall be fined not more than $5,000,000, or imprisoned not more than 35 years, or both.
> (2) CIVIL PENALTIES- Any mortgage professional who violates subsection (a) shall be liable for an amount equal to the sum of all finance charges and fees paid or payable by the natural person, financial institution, or purchaser who was defrauded unless the mortgage professional demonstrates that such violation is not material.[59]

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[57] S. 1222 at § 2.
[58] Olender, *supra* note 29.
[59] S. 1222, *supra* note 52 at § 2.

Criminal penalties this stiff properly punish the out-and-out victimization that has financially ruined families all over the country. Civil liability, while it could still be more severe, provides the avenue the victims will need to put their lives back in order. And speaking of judicial remedies for the victims, notice how else this bill sought to aid them in their pursuit of justice.

> Any person aggrieved by a violation of this section, or any regulation under this section may, but shall not be required to, file suit in any district court of the United States or any State court having jurisdiction of the parties to such suit
> (A) without respect to the amount in controversy;
> (B) without regard to the citizenship of the parties; and
> (C) without regard to exhaustion of any administrative remedies.[60]

While this jurisdictional provision may seem extreme, one cannot help but applaud it. Make no mistake, mortgage fraud is, and more importantly should be treated by the federal government as, a pernicious form of thievery more devastating to the victim than almost any other kind. It is the responsibility of the people's representatives to enact the strongest protections against it that they conceivably can.

S. 1222 went exactly nowhere. It garnered a single cosponsor, and its entire legislative history is the speech the sponsor made upon its introduction, and its referral to the Senate Committee on Banking, Housing and Urban Affairs,[61] the chairman of which, Sen. Chris Dodd (D-CT), received a sweetheart mortgage deal from none other than Countrywide Financial.[62] The bill was never seen or heard from again. Almost two years later, there are still no federal criminal penalties or civil liability designed to punish the commission of mortgage fraud.

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[60] *Id*.
[61] http://thomas.loc.gov/cgi-bin/bdquery/z?d110:SN01222:@@@X
[62] Daniel Golden, *Countrywide's many 'friends'*, CONDÉ NAST PORTFOLIO, Jun. 12, 2008, http://www.portfolio.com/news-markets/top-5/2008/06/12/Countrywaide-Loan-Scandal.

Just as unfortunately, since introducing S. 1222 to zero fanfare and almost zero support, the sponsor of the bill has not continued to make mortgage fraud a priority in his housing plans, which is a tremendous opportunity lost. His name is Barack Obama, and he is now the President of the United States. We can only hope that in his new office he can still see the wisdom of all his past efforts to get justice for the homeowners of America.