



Commercial Fraud Task Force Committee *ABI Committee News*

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The Sub-Prime Loan Mess: Where Did It Come From?

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The most disinterested spectator cannot help but know that there are major problems in the American housing market and major problems in America's largest banks. Stories about foreclosure rates, "sub-prime" mortgages and billion-dollar "write-downs" stream constantly from our popular media outlets. To pique the interest of those who normally turn off when they encounter the cryptic language and Byzantine structures concocted by Wall Street's financial engineers (which, fortunately, seems to be much of the population), these stories often focus on the sensational. Local reporters tell shocking stories of excessive borrowing, underfunded borrowers and foreclosure. In almost any major city, one can find working-class borrowers, who qualified for half-million dollar "sub-prime" mortgages, now unable to afford their piece of the American dream.

These stories, unfortunately, often gloss over the heart of the problem—the rapid and unfettered growth in the securitization of mortgages. Securitization, the packaging (*i.e.*, bundling) and reselling of mortgage loans as debt instruments, opened up vast sums of money for lending to American homebuyers. When the market was booming, institutional investors and hedge funds snapped up these instruments as fast as the investment banks could create them. The expected returns, especially for the riskiest "tranches" of these asset backed securities, were simply too attractive. Unfortunately, the voracious demand for securitized pools encouraged many to abuse the system and may have seduced others who did not fully understand the risks in investing.

A good way to understand securitization is to contrast it with traditional mortgage lending. Prior to the 1990s, people took out mortgages directly from local banks. The loan would go onto the bank's books, giving the bank the incentive to make sure that the borrower was credit worthy and that the property was worth what the borrower was paying. In other words, a lender's profits depended on the quality of their loans and the value of the underlying property. Securitization disrupted this crucial link between lender and borrower. Home loan originators made mortgage loans to homebuyers. The originators were not banks that kept the loans on their books, however. Rather, these originators sold the mortgages to investment banks who repackaged them as securities. (This, of course, freed up more capital for the originators to use to make still more

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mortgage loans.) To accomplish this, the investment banks pooled the borrowers' monthly payments and divided these payments into different tranches that were in turn sold to different classes of investors. More risk-averse investors, such as pension funds, purchased the AAA-rated tranches of these monthly payments. These slices get paid first, but at the cost of a lower interest rate. Those with a greater taste for risk purchased tranches offering higher interest. Investors in the riskiest tranches are the first investors to go unpaid should too many mortgage holders default. By pooling mortgages in this way, investment banks were able to turn B- mortgages into AAA-rated securities. One commentator referred to this mechanism as a "modern version of alchemy."^[1]

In theory, the alchemy of securitization works splendidly. All else being equal, securitization should have no real impact on the demand for housing or the type of borrowers qualifying for financing. But the real world is not so neat and tidy. By disconnecting the borrower from the party ultimately assuming the risk of default, securitization created moral hazards for a number of parties in the home loan industry. At best, these skewed incentives resulted in stupid lending decisions. At worst, these skewed incentives can result in large-scale fraud. While the full extent of the fraud that occurred during the recent housing boom will take a long time to uncover, recent reports and government investigations have provided an outline of the extent of the problem.

Take the case of one of America's largest mortgage lenders. Two of its businesses are home loan origination and the servicing of mortgages for the holders of mortgage-backed securities. With respect to its loan origination business, there is mounting evidence that employees within the company encouraged the sales force to shoehorn people, who could have qualified for standard fixed-rate mortgages, into exotic loan products with much higher fees and interest rates. First, salespeople's income depended on the profitability of the mortgages they sold, and the exotic loans meant higher interest rates and servicing fees for the lender. A former employee provided the following example: Assume that a broker could induce a borrower to take a \$1 million adjustable rate mortgage that required the borrower to pay a small portion of the real interest rate and no principal for the first year. If this loan also included a pre-payment penalty that required the borrower to pay six months' worth of interest at the reset rate of 3 percent plus the market rate, the broker would receive a \$30,000 commission – an amount substantially higher than if a traditional mortgage loan were made.^[2] Second, there is also evidence that the lender's employees pushed borrowers with prime credit scores into the sub-prime category because these loans generated larger profits. For the average borrower, the difference in cost between the two types of loans can run over \$5,000 dollars a year.^[3] Third, documents from the lender's sub-prime unit show how little concern the company had for the borrower's ability to repay the loan. One manual states that the lender would underwrite a loan that left only \$1,000 a month in disposable income after mortgage payments, for a family of four.^[4]

These lending practices, which many have termed "predatory," have piqued the interest of law enforcement and given rise to civil litigation. The Attorneys General of both California and Illinois have launched investigations of the company's lending practices. History suggests that these investigations will end up costing the company a large amount of money. In 2002, another lender paid \$484 million to settle mortgage abuse charges with all 50 states.^[5] In 2006, another lender settled similar charges for \$325 million.^[6] The feds have also gotten involved. The U.S. Trustee's office has started a multi-state investigation into whether lenders have been charging inappropriate

fees to borrowers going through bankruptcy. Finally, one lender faces a class-action suit that accuses the lender of inflating earnings and overstating the stability of its financial position.

Loan originators were not the only players with the incentive to engage in fraudulent conduct. In November, New York State's Attorney General filed suit against an appraisal company, alleging that the company caved to pressure from a large bank to inflate appraisals.^[7] The suit alleges that the bank demanded that the appraisal company use appraisers approved by the bank, rather than independent appraisers. Between April, 2006 and October, 2007, the appraisal company supplied the bank with 262,000 appraisals. Such conduct may not be confined to one lender. In a survey of 1,200 appraisers conducted earlier this year, more than 90 percent said they had felt "uncomfortable pressure" to inflate property values for lenders.^[8] This represents a dramatic increase from 2003, when 55 percent of surveyed appraisers reported such activity.^[9] Pressure to complete loans so that they could be packaged into mortgage pools created what one industry observer called "pressure... [of] pandemic proportion[,]," warning that the New York lawsuit against one lender "may be just the tip of the iceberg."^[10]

There are even schemes to defraud the cash-strapped borrowers unable to make payments on their overpriced mortgages. One type of fraudulent practice, dubbed mortgage-rescue fraud, targets homeowners who are equity-rich but cash-poor. Companies offer to loan these individuals money to help them make their mortgage payments. These loans can strip all of the borrower's equity in their home or, in some instances, the rescuing lender may fraudulently induce the borrower to sign over title to the property. Another type of fraud is a bit more old-fashioned. Insurance companies anticipate a rash of arsons by distressed homebuyers as more adjustable rate mortgages reset to higher payments.^[11]

The deflation of the U.S. housing bubble is just beginning. As time passes, the public will certainly learn more about what happened during the heady days of double-digit annual home price increases and exotic mortgages. Some of this information will almost certainly show that many players in the housing game engaged in questionable conduct, with the likelihood of many years of litigation throughout the country.

^[1] Harold Brubaker, *CDOs are Complicated—and Important. The Alchemy at the Center of the Subprime-Loan Crisis*, Philadelphia Inquirer, Dec. 11, 2007 at D.

^[2] Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. Times, Aug. 26, 2007, at 3.

^[3] *Id.*

^[4] *Id.*

^[5] Marc Lifsher, *2 States Probe Countrywide Home Loans*, L.A. Times, Dec. 14, 2007.

^[6] *Id.*

^[7] Ken Harney, *Suit Links Mortgage Mess to Inflated Appraisals*, Baltimore Sun, Nov. 1, 2007.

^[8] Carolyn Said, *Pushed to Boost Home Prices*, S.F. Chron., Nov. 3, 2007.

9] *Id.*

10] *Id.*

11] "Fraud Investigators Brace for Arsons from Subprime Mortgage Crisis," *Insurance Journal*, Dec. 3, 2007, <http://www.insurancejournal.com/news/national/2007/12/03>.