

FINANCIAL FRAUD ENFORCEMENT NETWORK:

Will Bankers Be Prosecuted For Fraud?

January 26, 2012

*By Curt Novy, President
Corporate Mortgage Advisors*

Corporate Mortgage Advisors (CMA) is a leading nationwide financial & mortgage fraud firm specializing in white collar crimes. The firm has been in business since 1997. CMA's primary consulting projects focus on bank fraud, lending standards and practices, and sub-prime lending abuses.

CMA's team of highly skilled professionals analyzes confidential governmental data, ranging from FBI recordings to IRS & HUD investigations to Grand Jury testimony. The information contained in these highly sensitive investigations provides a unique "insiders perspective" of fraud investigation.

Financial Fraud Enforcement Network

President Obama formally announced his new mortgage fraud unit in his State of The Union address that will investigate a wide range of alleged bank and lender abuses that led up to the financial crisis of 2008. The new Financial Fraud Enforcement Network will focus on the loan origination and securitization of residential mortgages. The Enforcement Network will pursue both civil and criminal investigations which should concern high level bankers and lenders who may be targeted for prosecution.

According to industry sources in the field of lending risk management, senior level executives had direct knowledge of lending abuses and condoned allowing loan origination units to sell unsafe and risky loan programs that were doomed to fail. Some bankers and lenders essentially turned a blind eye to red flags in the loan origination process, such as allowing borrowers with questionable income sources or no documented employment to obtain large mortgages with little or no down

payment. Buying a home with no down payment or “skin in the game” was a recipe for disaster when combined with no income verification type loan programs.

Most of these risky loans were identified as sub-prime characterized by lax underwriting guidelines, high interest rates, and emphasis on borrower credit score to qualify for loans. Then, lenders quickly passed off the risky loans to Wall Street who packaged large loan portfolios into bonds that were generally described as safe & secure transactions. Wall Street executives who pitched these loans to investors will be scrutinized by investigators along with bond rating agencies to evaluate their knowledge of risk.

When the nationwide real estate market began to slow in 2006-2007, many of the sub-prime loans began to default in great numbers because borrowers were not truly qualified to buy homes. In turn, the lenders who originally sold off these loans to Wall Street experienced high levels of what’s called “investor buy-back demands” based on underlying lapses in mortgage underwriting. In lenders’ haste to originate and sell loans, lenders failed to catch rampant fraud that was prevalent in the market based on investor speculation. When lenders were required to re-purchase the faulty loans, they struggled financially and most lenders went out business. Banks were shut down in large numbers by regulators and inventories of unsold bank owned homes swelled to historic levels.

To date, a number of high profile governmental investigations into executive level bankers’ participation in fraud have yet to yield a criminal conviction. The public, however, is clamoring for high level prosecution to pay for alleged abuses of trust and the devastating impact on financial markets, the economy, and on real estate home values.

How will the new governmental unit investigate fraud?

Since the new investigative unit will have significant resources to draw upon, the focus and depth of investigations will likely concentrate on why questionable loans were granted and how these risky loans were sold to Wall Street. A great deal of work will entail documenting that lending executives knew the loan programs were risky but still sold these loans to investors as safe investments.

Will Prosecution of Bank Executives Result In Convictions?

Successful executive level prosecution will depend on prosecutors' ability to identify corroborating evidence, such as internal emails and credit management reports that identified poor performance of sub-prime loans that was communicated to the executives. If top management had advance or material knowledge of loan fraud and defaults associated with these risky loans, then they may have exposure to prosecution. Most executives in lending will likely claim they did not directly know just how risky these loans were and will blame the loan defaults on high unemployment and the downward spiral of home values. Prosecution of high level executives will not be an easy task but some convictions are possible.

Most criminal prosecution cases will be built on documenting a strong foundation of advance knowledge and deep understanding of risk combined with a willingness to pass that risk on to unsuspecting investors. Lending executives, if indicted, will present a defense that they were unaware of the underlying risk associated with these types of sub-prime loan products, often called "liar loans" in the industry.

The problem with a defense plan that focuses on lack of risk is that they leave themselves and their banks open to civil litigation over negligent lending practices. In fact, some prosecutors who've prosecuted individuals of mortgage fraud schemes have outright stated in court that lenders were negligent and ignored red flags that should have been investigated.

The next few years will produce some interesting high level prosecutions and the investigators and prosecutors will build strong cases against some bank executives. Conviction of these executives, however, will prove difficult but not impossible. It is more likely that civil litigation will resolve these high level cases and billions of dollars in settlements will take place.

Note: Curt Novy is a mortgage & real estate expert and is not a government investigator or police officer. In addition, the work of CMA does not include aspects that include a requirement for a private investigator's license. Some fraud investigation work is contracted to licensed investigators.