9-23-2010

Testimony by Benjamin B. Wagner Before the FCIC

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TESTIMONY
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FINANCIAL CRISIS INQUIRY COMMISSION
SEPTEMBER 23, 2010
SACRAMENTO, CALIFORNIA

Distinguished Members of the Commission, thank you for the invitation to speak before you today about the Department of Justice's efforts in the Eastern District of California in combating mortgage fraud. The mortgage fraud crisis has hit this district particularly hard, with our communities suffering some of the highest rates of foreclosure in the country. I am pleased to have this opportunity to share some information with you today about what we have learned here in investigating and prosecuting mortgage fraud, and I hope it will be helpful to the Commission in its important work in identifying the causes of the financial crisis in this country.

Earlier this year, you heard testimony from Attorney General Eric Holder and Assistant Attorney General Lanny Breuer, both of whom described in detail the Department's enforcement efforts in fighting financial fraud. As you know, the Department is committed to holding wrongdoers accountable for their actions, and to remedying financial harms where possible. In fighting financial fraud, we vigorously pursue substantial jail sentences, restitution to victims, forfeiture of crime proceeds, and the imposition of severe monetary penalties through civil suits. While terrorism remains the Department's highest concern, our mission today is also focused on the high-priority area of financial fraud.

In response to the unprecedented financial crisis, late last year President Obama created the Financial Fraud Enforcement Task Force, over which the Attorney General serves as chairman. A Mortgage Fraud Working Group has been established as a part of this Task Force, on which I serve as co-chair. The Financial Fraud Enforcement Task Force is comprised of officials from across federal, state, and local governments, and is an historic collaboration of criminal, civil, and regulatory officials dedicated to pro-active enforcement and prevention strategies in fighting financial crimes. The Task Force has allowed us to pool our collective resources to identify and investigate past and on-going mortgage fraud. We have strengthened our efforts to prosecute, convict, and punish those who commit fraud, in order send a powerful deterrent message. The Mortgage Fraud Working Group has worked to build relationships between federal, state and local prosecutors and regulators, to increasing training and information sharing, and to more fully deploy civil enforcement strategies. You can learn more about the Task Force at its website, www.StopFraud.Gov.

As the Commission is aware, it is not generally within our expertise to opine on the causes of the financial crisis. The Department fights terrorism and crime, and our resources are focused on the investigation and prosecution of violations of the federal criminal laws. Accordingly, the focus of my testimony today is on the Eastern District of California and what we as prosecutors have seen in this district concerning the financial crime of mortgage fraud – how it was perpetrated and who was victimized. I will also share with you with specific information about what the Department has done to fight mortgage fraud in this district.

The Eastern District of California is the eighth most populous of the nation's 94 judicial districts and has nearly seven million residents. Our District encompasses six large urban areas: Sacramento, Fresno, Bakersfield, Stockton, Vallejo, and Fairfield, and extends over 87,000 square miles, including 34 counties that reach from the Oregon border in the north down to Bakersfield in the south, and from the coastal mountains in the west to the Nevada border in the east. This region, and particularly the Central Valley, was an area of tremendous growth in the 1990s and early 2000s, and that growth was accompanied by a boom in new home construction.

Currently, communities in the Eastern District of California are suffering some of the worst effects of the mortgage-related financial crisis in the nation. This year, five of the top ten per capita foreclosure cities in the country are in our district, and include Modesto, Merced, Stockton, Bakersfield, and Vallejo/Fairfield. Four of these cities are within the top ten cities in the nation with underwater mortgages – Modesto, Merced, Stockton, and Vallejo. In Stanislaus County this year, where Modesto is the county seat, one out of every 102 homes has been subject to foreclosure. In 2008, when the mortgage fraud crisis was just starting to come to light, California had the second highest foreclosure rate in the country, after Nevada, with Stockton, Merced, and Modesto being the top three ranked cities nationally for number of foreclosures.

Although the mortgage fraud we have seen in this district takes a number of forms, the fraud schemes prevalent during the period from 2003 through 2008 were loan origination schemes, all of which essentially come down to one thing – material lies to the mortgage lender. Mortgage fraud perpetrators primarily lied about borrowers' qualifications for obtaining a mortgage loan, about the true market price of the property securing the mortgage loan, and about what the money being borrowed was to be used for. In our work, we have seen mortgage professionals who lied to increase their already-generous commissions, real estate investors who lied to finance property-flipping schemes, buyers and sellers who lied to extract equity from homes or simply to strip cash out of the transaction, and builders who lied and used straw buyers to get properties off their books in a down-turning market. One thing that we have learned is that as the housing market changes, the nature of fraud schemes relating to that market also change, so that the crime we refer to as "mortgage fraud" describes a range of schemes that are constantly evolving.

At the same time, it is important to note that, although the extent of the mortgage fraud schemes occurring during this period are clear as we sit here today, it took the drop-off in the housing market to bring them to light. Through our investigations, we have uncovered countless transactions from the middle part of the decade that are riddled with fraud. But, as long as it was possible to sell a house at a profit, or easily re-finance an adjusting mortgage, there were few complaints. Buyers were spared from default, and lenders fully recouped their investment by a constantly improving marketplace. It was not until the homeowners caught up in these schemes were suddenly stuck with mortgages and interest rates they could not afford, and homes they could not sell, that they realized their predicaments and contacted authorities. Similarly, lenders did not have reason to audit their files for fraud, file Suspicious Activity Reports, or refer cases to law enforcement when loans were being re-paid in full. For these reasons, our mortgage fraud enforcement efforts really took off in 2007 and 2008, once the backsliding market brought the fraud into high definition. Once these investigations developed, the extent of the fraud, reaching back as far as 2003, became visible.

Our investigations have shown that at the height of the mortgage boom in the middle part of this decade, sub-prime lenders were eagerly and aggressively selling their purchase and re-finance mortgage loans. These loan products were sold by the lenders' own account executives in concert with independent mortgage brokers, both of whom earned substantial commissions on every home purchase or mortgage re-finance. These commissions, while substantially increasing the cost of the loan to the consumer, were not as transparent as they are today, and provided an incentive to generate as many loans as possible.

Many individuals who acted as mortgage brokers had little or no previous training in the field, and often were not even licensed, operating instead under the license of an off-site broker who may not have exercised any actual oversight. Some of the off-site brokers operated multiple unlicensed sub-offices in different locations, each producing scores of fraudulent loans. Licensing and professional development requirements for appraisers, title officers, and real estate salespeople were low enough to allow quick entry by individuals more interested in earning quick money than adhering to professional standards.

"Stated income" loans were widely available, requiring little or no proof of income and employment, and leading some unscrupulous mortgage brokers and account executives to simply create income numbers to justify a loan. With compensation tied almost entirely to the amount and volume of loans produced, and large bonuses available to high-producers, mortgage brokers and account executives had a strong incentive to push loans through.

With loans being re-sold on the secondary market shortly after they were closed, these loan originators were insulated from the consequences of their bad loans. And, in the days of exponentially rising home prices, borrowers and banks were protected from the effects of fraud by the easy ability to re-sell the home, and thereby recoup the loan. The unprecedented rise in market prices for homes during this time also allowed room for individuals to falsely inflate sales prices, and in turn loan amounts, in order to fraudulently obtain cash-back at the close of escrow.

In one case we investigated and prosecuted, mortgage fraud came to light as a result of the defendant's use of an individual's stolen identity, and led to uncovering a property flipping scheme encompassing approximately 40 properties, primarily in the Stockton area. In that case, the defendant, who was not a licensed real estate professional, recruited unsophisticated buyers – often straw buyers – to buy his properties. As in many cases we have seen, buyers were recruited from immigrant communities and typically spoke little or no English. The defendant then worked with a corrupt mortgage broker he had a relationship with to obtain loans on the buyers' behalf, often using fabricated and false information to qualify them, and often based on above-market sales prices that he simply set himself. Subsequently, that mortgage broker funneled these loans to a lending institution with which he regularly worked, and where he paid kickbacks to an employee who took the fraud even further, using old-fashioned cut and paste jobs and computer editing to falsify loan application data, airbrush appraisal photos, and create borrower verification documents and bank statements out of whole cloth. All of these individuals have pleaded guilty to criminal charges, and have fully detailed their actions to the government.

In Bakersfield, the FBI uncovered a scheme being conducted by a locally-owned real estate firm and its in-house mortgage brokerage business. As a loan officer who pleaded guilty described, he and others within the company routinely and falsely overstated borrowers' income, and misstated employment, occupation, and buyers' intent to occupy the home as a primary residence. Additionally, the loan officer applied for and received loans to purchase eleven properties of his own worth $4.4 million, by falsely representing his income, assets, and liabilities, and lying about his intent to occupy the property.

In another case involving a major homebuilder in Chico, the defendant had a large volume of unsold homes in his inventory as the market started cooling in 2006. In order to sell these homes, the defendant worked with unlicensed mortgage brokers and numerous straw buyers to orchestrate sales at prices substantially above the market price. By creating a sale above market price, the defendant received loan proceeds from the lender in an amount high enough to make a profit, and pay "rebates" to the straw buyers in amounts ranging from $40,000 to $60,000. These "rebates" were not disclosed to the lender, nor would they have been approved by the lenders if they had known about them. Most of these homes have now fallen into foreclosure, while others have been subject to short sales, resulting in losses to date of $5 million to the lenders. In a related scheme, we have seen promoters approach builders across five states to inflate sales prices in multiple residential developments.

In other examples, we have heard witnesses describe how account executives of the lenders themselves would sit down in the offices of mortgage brokers, both licensed and unlicensed, to train them how to inflate income, generate false supporting documents, and package fraudulent loan files. Those mortgage brokers trained others who came and went in the fluid atmosphere of the mortgage loan business, creating a web of fraud that extended far and wide in this district. We have seen mortgage brokers encouraging buyers who are not qualified to buy a single property buy four to six properties within the space of two months, indicating to the lender that each is a primary residence, and hiding the multiple transactions by conducting them so close in time that they do not show up during the title searches conducted during the escrow process. At times, the same escrow companies and appraisers would handle all of the transactions for that one borrower – each of these mortgage professionals being in a position to know that all properties were being represented to the lender to be "primary residences." And, we have seen mortgage brokers and buyers create and submit false liens and expenses for, among other things, improvements and construction in order to obtain otherwise unavailable cash-back from the transaction.

In the end, these schemes often resulted in homes being owned by people who could not afford them or never intended to live in them. Not only that, but buyers were often sold loan products with terms substantially more beneficial to the lenders and brokers than to the buyers, resulting in interest rate re-adjustments, pre-payment penalties, and other terms injurious to the buyer. The larger effect of these schemes is playing out right now, years later, in communities throughout our district.

In many communities where these fraudulent practices took root, they led to a gradual but broad inflation of home values in the middle of this decade, as homes sold at fraudulently inflated prices were then used as comparables for other homes on the market. Later, when homes that had been purchased by straw buyers or sold at inflated prices fell into default and then foreclosure, it exacerbated market trends in the other direction, reducing the value of many homeowners' equity – often their most important asset. Many communities in this district are dotted with foreclosed homes, which depress property values and serve as magnets for vandalism and petty crime.

While mortgage fraud has taken a substantial toll on the communities within the Eastern District of California, the Department has devoted significant resources toward fighting it here, and we have achieved measureable success. These prosecutions are extraordinarily complex and time-consuming given the document-heavy nature of mortgage lending transactions. Further, the vast majority of our mortgage fraud prosecutions involve multiple defendants who operated in various capacities during mortgage loan transactions, as well as long-running and wide-ranging conspiracies.

In May of 2007, this office initiated a mortgage fraud task force in Sacramento, comprised of members of the U.S. Attorney's Office, the FBI, IRS-CI, the California Department of Real Estate, HUD-OIG, and the United States Bankruptcy Trustee. In 2008, as a result of the work of this task force, 49 defendants were charged with mortgage fraud crimes, which was among the highest numbers in the nation for that year. This task force was expanded later in 2008 in an effort to bring more federal, state, and local agencies into collaboration in attacking mortgage fraud in our district. Today, we have two active mortgage fraud task forces dedicated to fighting mortgage fraud – one in the Sacramento Division, and one in the Fresno Division.

These task forces consist of federal, state, and local investigators and prosecutors, and now include the FBI, IRS-Criminal Investigation the HUD Office of Inspector General, U.S. Secret Service, U.S. Postal Inspection Service, the Department of Veterans Affairs Office of Inspector General, the FDIC Office of Inspector General, the U.S. Department of Labor Office of Inspector General, the California Department of Real Estate, the California Department of Corporations, the California Department of Financial Institutions, the California Office of Real Estate Appraisers, the Social Security Office of Inspector General, USDA Office of Inspector General, the U.S. Trustee's Office, the California Attorney General's Office, and the District Attorney's Offices from a number of counties within our district.

Our training of prosecutors and investigators has also increased in response to the mortgage fraud crisis. In April of 2009, we held a training session in Sacramento attended by over 100 participants from federal, state, and local agencies, educating attendees about the mortgage loan process and covering emerging mortgage fraud crimes. Members of these task forces have participated in FBI mortgage fraud training conferences, and in Department-wide training on mortgage fraud at the National Advocacy Center in Columbia, South Carolina.

In aggressively pursuing mortgage fraud, federal, state, and local law enforcement agencies in this district have dedicated significant resources to the effort. The FBI currently has 10 agents and one contractor in its offices throughout the district assigned to investigate mortgage fraud cases, supported by a number of financial analysts, forfeiture personnel, and administrative staff. The IRS, Postal Service, Secret Service, and HUD have assigned agents to work mortgage fraud cases. My office has assigned additional Assistant United States Attorneys to handle mortgage fraud cases, and received funding in Fiscal Year 2009 to hire two new permanent mortgage fraud AUSAs and a new permanent mortgage fraud paralegal. All of those personnel are now in place and handling new cases. This year we received funds to hire another AUSA dedicated to affirmative civil enforcement, including mortgage fraud. The personnel dedicated to mortgage fraud in these offices have been critical not only to pursuing new mortgage fraud cases, but in completing the litigation started in previous years, and staying ahead of new fraud schemes that are developing.

In addition, since 2008, members of the Eastern District of California's Suspicious Activity Report Review Team have reviewed more than 6,700 Suspicious Activity Reports (SARs) filed with the Financial Crimes Enforcement Network (FinCEN) by financial institutions, looking for indicators of mortgage fraud activity. Numerous mortgage fraud investigations developed out of those referrals, which were then pursued using traditional investigatory methods.

In 2010, starting on March 1st and ending in June, the Financial Fraud Enforcement Task Force, under the auspices of the Mortgage Fraud Working Group which I co-chair, oversaw a coordinated nationwide takedown entitled Operation Stolen Dreams, which included federal and state criminal prosecutions and civil actions across the United States. This initiative allowed law enforcement in the Eastern District of California and throughout the country to coordinate their on-going efforts in a massive sweep aimed at publicizing mortgage fraud prosecutions and deterring future mortgage fraud crimes. During the time period encompassed by Operation Stolen Dreams, criminal charges were brought against over 1,500 defendants, and civil charges were brought against nearly 400 defendants, resulting in accountability for an estimated loss exceeding $3 billion.

In our district, 46 individual defendants were charged with felony mortgage fraud offenses during the sweep. Several participating District Attorney's Offices also filed criminal mortgage fraud cases. Additionally, a number of federal guilty pleas were secured, and one defendant was sentenced. Restitution orders and forfeiture judgments have also been obtained. Additional federal mortgage fraud cases were filed prior to the commencement of Operation Stolen Dreams, and many mortgage fraud investigations are continuing, with future charges anticipated.

Next week, my office and the Mortgage Fraud Working Group will be hosting a mortgage fraud summit in Fresno. It will be attended by leaders of the Department of Justice including Assistant Attorney General Tony West of the Civil Division, and specialists in mortgage fraud with the FBI, HUD-OIG and other agencies. The event will bring together law enforcement and regulators with federal, state and local agencies, industry participants, advocates, and members of the public to share information and strategies, discuss trends, and enhance collaboration.

Despite all that has been accomplished, much remains to be done. In recent years, as the market has dropped and credit has become harder to obtain, the mortgage fraud schemes in our district have changed. Taking advantage of distressed homeowners desperate to stay in their homes, mortgage fraudsters have turned to "foreclosure rescue" and "loan modification" schemes. In these schemes, homeowners facing default or foreclosure are promised that their loan principals can be reduced to below current market values, so they can afford their monthly payments and get out from under water. Victims are charged up-front fees of thousands of dollars, and convinced to transfer some portion or all of their property interest in their homes to nominees. Often, the fraudsters abuse federal bankruptcy proceedings and local county recorders' offices to cause delays and make their actions appear legitimate. In the end, homeowners are often left worse off than they were, evicted from their properties, further in default, and even without title to their own homes. In some cases, nominee titleholders have stripped whatever equity that did exist in the homes, leaving victims with significantly less than they started with. We have already prosecuted several large foreclosure rescue and loan modification schemes, and we expect to handle more of these types of cases on a going-forward basis.

In conclusion, the Eastern District of California has been one of the hardest hit by the mortgage fraud crisis, and the people in our communities and across the nation have suffered the consequences of it – from steeply reduced home values, to ruined credit, to foreclosures and evictions. Lenders have suffered losses as a result of fraud by real estate and mortgage professionals, their own employees, and by buyers, all of whom took advantage of an atmosphere where fraud was rife and commissions were easy. This district has dedicated extraordinary resources to pursuing those who perpetrated mortgage fraud, and continues to increase its efforts, follow new trends, and achieve significant results.

That concludes my prepared testimony, and I look forward to addressing questions from members of the Commission.