

## THE ROLE OF DUE DILIGENCE IN THE SUBPRIME MORTGAGE CRISIS

August Blass [FNaa1]

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August Blass, the CEO of National Loan Auditors Inc., discusses the role that lax due-diligence standards played in creating the subprime mortgage crisis and offers advice on how attorneys can use forensic loan audits to reveal legal violations and protect client assets.

In a pivotal episode of the canceled television series “Eli Stone,” the senior partner of a law firm has an epiphany that leads him to reinvent his firm into one with great social conscience. He is at a meeting with one of his rapacious corporate clients, a subprime mortgage lender, who says with a smirk, “We didn't *make* them take out loans they couldn't afford!”

It is a revealing moment, not so much as a comment on subprime lenders, but as an indication of how little the American public (and especially TV writers) understand about the lending business. The implication is that lenders intentionally made loans to people whom they expected to default, and that's just not true.

### ***Following the Value Chain***

While it is true that subprime lenders expected the real estate market to make riskier borrowers less risky with escalating home values, they also expected payments to be made in the meantime. No lender, outside of some unscrupulous “hard money” types, *wants* borrowers to default in order to take properties back, and that's something many people have a difficult time understanding. Even more important to understand is that in the secondary market for mortgage loans, the maker of the loan is seldom the end investor or servicer. For these originators, early defaults meant they had to buy the loans back, which quickly put many of them out of business. Many types of lenders were affected, not only subprime, but also those specializing in “Alt-A” loans (typically made to borrowers with good credit histories but with non-W-2 employment) and “stated income” loans, where no employment or income is verified. Many of these lenders took loans originated by mortgage brokers, which are generally very small businesses to whom there is no recourse.

When lenders made mistakes in their upfront due-diligence process in the interests of competitive expediency, those mistakes were passed on to mortgage banks and investors up the value chain, and eventually to Wall Street. The mortgage brokers didn't expect these loans to default either, but they were less concerned than the lenders should have been because they had no particular "skin in the game."

Wall Street had lots of experience securitizing loans for others and selling those securities to pension funds, mutual funds and other securities buyers, but little experience in underwriting credit risks itself. Wanting a piece of the attractive margins that lenders were claiming in the process, the investment banking community waded into the lending business up to its Gucci-tied necks. It counted on independent firms to perform loan-quality audits commonly referred to as "re-underwriting" to tell it where the risks were, as well as having the loan pools rated by traditional rating agencies. However, there were some basic flaws in the process.

### *The Due-Diligence Myth*

For starters, the auditing firms typically performed not an audit, but a cursory check of data against a spreadsheet (known as a "bid tape," an antiquated term from the days when computers mostly used tape) containing 50 to 70 data bits supplied by the lender selling the loans. The auditors' instructions were seldom to issue a judgment on whether the loans were good, but rather on how closely they met the parameters of the bid tape and the loan program's guidelines.

For example, if a particular loan program had a 90 percent loan-to-value maximum, the auditor would check the loan amount against the appraisal. While looking at the appraisal, the auditor would normally check to see if the basics of the appraisal rang true, such as the proximity of comparable sales, the appropriateness of the comparables and whether the photographs made sense. While these are good things to check, they still don't reveal much about the borrower's willingness or capacity to repay the loan. Had these contractors been hired to pass judgment on whether making these types of loans was a good idea, many, perhaps most of them, would never have been made. A quick glance into the room where these workers toiled would tell you a lot. They were mostly well-traveled, highly experienced lending types with a good amount of gray hair among them. Later, because of the incessant demand, the contractors began hiring less experienced people, but for the most part, these "re-underwriters" knew their business. They just were given the wrong mission.

It is fair to say that many longtime lending professionals were concerned about the increasing numbers of stated-income loans made to borrowers with high credit scores, much less ones made to those with low credit scores. But the prevailing attitude was "if Wall Street wants to buy them, we'll make them." Caveat emptor, in other words. At the same time, when auditors found discrepancies, they were encouraged to find other "compensating factors" both by their investment banking employers and the lenders on whose sites these field audits were taking place. No one wanted loans to be excluded or turned down, and the auditors wanted to continue to be hired.

This lending "perfect storm" continued on to Lower Manhattan, where most of the rating agencies reside. They were in the prickly position of being the ones to rate the securities issues, but they, like the re-underwriting contractors, wanted to continue to be hired to perform their function. Their analysts basically used previous performance

models to predict the future for these more aggressive loans, and they might as well have been comparing apples to citrus. There really was no comparing a W-2 employee in an 80 percent loan-to-value loan with a gardener who stated his income at five times its actual value as a "landscape engineer" in order to qualify for a loan at 90 percent or higher. Furthermore, unlike the re-underwriter, the rating agency analyst had no access to the loan files he was rating -- he had a glorified bid tape whose data elements he loaded into his modeling software. Using flawed assumptions and knowing little, if anything, about what distinguished a good loan from a bad loan, the rating agencies issued AAA ratings to very poor risks.

Between the re-underwriting audits, the overly optimistic ratings and the mental pre-spending of their bonus incomes, bond traders freely spread the doomed securities among their best clients with little expectation of what was to come. The lack of real due diligence floated like the tip of a Matterhorn-sized iceberg directly in the path of the oncoming Titanic, its unsuspecting passenger/investors serenely confident in their safety. Despite claims by some industry experts to have foreseen the entire episode, no one in finance or investments really understood that when the ship went down, the global economy would be threatened to the extent we have witnessed. Had even *one* of the senior subprime or Wall Street executives had a vision in 2006 that less than 30 months later, thousands of lawyers would be reading an epitaph for their business in this publication, much might have changed. And, it wouldn't have taken much to have avoided the whole thing, just the right kind of due diligence and a lot less greed on the part of everyone involved, including many consumers.

### ***The Right Kind of Due Diligence***

The "right kind of due diligence," the sort that could have short-circuited the entire debacle, is a forensic loan audit by an expert not only sound in lending principles, including fraud detection, but also in the legal aspects of mortgages. Sometimes, they all blend together. For example, stated-income loans have a real public purpose: providing credit to non-W-2 borrowers who have sufficient income to repay a loan but are self-employed, often in consulting or contracting roles. These loans perform well when made properly, but when expanded to include those trying to conceal their real income, they are a train wreck.

Stated-income loans became a frequent means to do just that, and when originators were stymied by debt-to-income ratios that failed to meet lender guidelines, they could tell their borrower "we'll take it 'stated'" and pay a small premium in rate to bypass the lender's safeguards. The lender contact was typically an account executive (working on commission) who wanted to see the loan accepted and winked at the practice. As a result, the stated-income loan and its even more destructive sibling, the "no income/no asset" loan, were abused.

Stated loans are perfectly legal on the federal level, not violating the Truth In Lending Act, Real Estate Settlement Procedures Act, or Home Ownership and Equity Protection Act. However, many states, among them California, Nevada, Michigan and Georgia, have provisions that make it unlawful to make stated-income loans where there is no real assurance that the borrower has the ability to repay. If even aware of these statutes, lenders and brokers ignored them and made the loans with little attempt to verify the income the borrower claimed on the application. In most cases, verification could have

been as simple as looking at a tax return to find out if the borrower in fact was a W-2 employee, which many of them were. Small wonder they became known as "liar loans" in the industry. The forensic approach to prefunding and post-closing audits would readily have caught virtually all the instances of obvious fraud and most of the more clever ones, as well as the blatant instances of state law violations now being unearthed.

### ***The Role of the Legal Profession in Saving Homes From Foreclosure***

Today, saying attorneys will play a key role in helping borrowers find ways to stay in their homes is an understatement of magnificent proportions. With all the misapplications of lending rules and regulations, coupled with the imperfections in disclosures and loan processes, the legal profession becomes critical in raising the sunken vessel that is home ownership in America. Lawyers specializing in real estate and mortgages suddenly find themselves the new best friends of borrowers across the land, with plenty to be done in the coming year. Forensic loan auditing will help make hundreds of thousands, even millions, of cases work to the benefit of their clients by revealing lender mistakes, predatory lending practices and other legal violations. Over time, courts around the country will become well versed on the core issues surrounding the wave of foreclosures they will see, and lenders will be eager to make modifications that will scrub away the imperfections of the original loans.

Things are going to get more complicated before this crisis is over. The American Housing Rescue and Foreclosure Prevention Act of 2008, signed into law by President George W. Bush last July, could help in a number of cases, but it also puts the federal government in a partner-like position with the American public. In addition to expanded tax credits and other enhancements to help homeowners refinance into loans they can maintain, the law comes with a sliding scale by which borrowers relinquish 50 percent to 100 percent of their financial gains to the government if they sell the home within five years. This makes sense on many levels: why shouldn't the government be allowed to recover part of its costs in bailing out consumers if they benefit from housing appreciation later?

However, it also brings up a number of legal and ethical questions that may well keep borrowers and their lawyers busy until around 2013 or 2014, when these five-year provisions start hitting. Once again, forensic audits of these transactions will be an important tool in protecting consumers' assets when it comes time to divide the proceeds and determine with precision what goes to the government and what remains with the borrowers. The prospect that this could lead to an entirely new real estate crisis in a few years is certainly not beyond the realm of possibility. After all, few could have imagined just months ago that we would have migrated from an open-market financial system to one where the government approves, funds and sells loans -- and then buys them in the form of securities.

### ***Forensic Audits: A New Breed of Analysis***

For those not familiar with forensic loan audits, they are highly detailed reviews of loan files performed for the specialized needs of the legal community. Requiring a depth of understanding not found in traditional loan-audit practices, the forensic audit exposes federal, state, county and statute violations, along with predatory lending practices

perpetrated on borrowers, sometimes without the lender's specific knowledge. Forensic auditors use mortgage, legal and accounting skill sets in conjunction with state-of-the-art compliance and auditing technologies to help legal professionals quickly determine what course of action to pursue with lenders and other parties to produce the best possible results for their clients.

Forensic loan audits comprise several different types, each with a different audience in mind. The audit created for loan-modification companies and attorneys is a lengthy document prepared with more than 100 action steps, resulting in a detailed report on where the loan had mistakes, from both an underwriting and a legal perspective, that will assist lawyers in dealing with mortgage lenders.

Another type of forensic audit is to help judges and trustees to determine where violations and illegalities occurred to assist them in rendering decisions. An elaborate, 160-step version designed to protect lenders from future liabilities also is available.

Regardless of the audience, forensic audits can be basic and simple or comprehensive and elaborate, depending on the needs of the attorneys. The comprehensive ones generally include the forensic loan audit with a compliance-analysis report, a post-closing underwriting review and analysis, and a summary of applicable statutes and controlling case law. The best forensic audits contain information that law firms, regardless of their expertise in mortgage and real estate law, should always have in their possession as they construct their cases for loan modifications or other actions.

Never before has there been such opportunity as that we are seeing now for the legal profession to make a tremendous impact in the lives of Americans. The housing crisis is so extensive that it reaches across all economic and geographic boundaries, affecting the rich and poor alike. Having the right information when heading into court can make all the difference for a law firm's chances of success and clients' financial future.

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