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JPMorgan Chase Engaged in Mortgage Fraud. The Securitization Fraud That Collapsed the Housing Market

The Stone that Brings Down Goliath? Richmond and Eminent Domain

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Web of Debt

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In a nearly $13 billion settlement with the US Justice Department in November 2013, JPMorganChase admitted that it, along with every other large US bank, had engaged in mortgage fraud as a routine business practice, sowing the seeds of the mortgage meltdown. JPMorgan and other megabanks have now been caught in over a dozen major frauds, including LIBOR-rigging and bid-rigging; yet no prominent banker has gone to jail. Meanwhile, nearly a quarter of all mortgages nationally remain underwater (meaning the balance owed exceeds the current value of the home), sapping homeowners' budgets, the housing market and the economy. Since the banks, the courts and the federal government have failed to give adequate relief to homeowners, some cities are taking matters into their own hands.

Gayle McLaughlin, the bold mayor of Richmond, California, has gone where no woman dared go before, threatening to take underwater mortgages by eminent domain from Wall Street banks and renegotiate them on behalf of beleaguered homeowners. A member of the Green Party, which takes no corporate campaign money, she proved her mettle standing up to Chevron, which dominates the Richmond landscape. But the banks have signaled that if Richmond or another city tries the eminent domain gambit, they will rush to court seeking an injunction. Their grounds: an unconstitutional taking of private property and breach of contract.

How to refute those charges? There is a way; but to understand it, you first need to grasp the massive fraud perpetrated on homeowners. It is how you were duped into paying more than your house was worth; why you should not just turn in your keys or short-sell your underwater property away; why you should urge Congress not to legalize the MERS scheme; and why you should insist that your local government help you acquire title to your home at a fair price if the banks won't. That is exactly what Richmond and other city councils are attempting to do through the tool of eminent domain.

The Securitization Fraud That Collapsed the Housing Market

One settlement after another has now been reached with investors and government agencies for the sale of "faulty mortgage bonds," including a suit brought by Fannie and Freddie that settled in October 2013 for $5.1 billion. "Faulty" is a euphemism for "fraudulent." It means that mortgages subject to securitization have "clouded" or "defective" titles. And that means the banks and real estate trusts claiming title as owners or nominees don't actually have title – or have standing to enjoin the city from proceeding with eminent domain. They can't claim an unconstitutional taking of property because they can't prove they own the property, and they can't claim breach of contract because they weren't the real parties in interest to the mortgages (the parties putting up the money).

"Securitization" involves bundling mortgages into a pool, selling them to a non-bank vehicle called a "real estate trust," and then selling "securities" (bonds) to investors (called "mortgage-backed securities" or "collateralized debt obligations"). By 2007, 75% of all mortgage originations were securitized. According to investment banker and financial analyst Christopher Whalen, the purpose of securitization was to allow banks to avoid capitalization requirements, enabling them to borrow at unregulated levels.

Since the real estate trusts were "off-balance sheet," they did not count in the banks' capital requirements. But under applicable accounting rules, that was true only if they were "true sales." According to Whalen, "most of the securitizations done by banks over the past two decades were in fact secured borrowings, not true sales, and thus potential frauds on insured depositories." He concludes, "bank abuses of non-bank vehicles to pretend to sell assets and thereby lower required capital levels was a major cause of the subprime financial crisis."

In 1997, the FDIC gave the banks a pass on these disguised borrowings by granting them "safe harbor" status. This proved to be a colossal mistake, which led to the implosion of the housing market and the economy at large. Safe harbor status was finally withdrawn in 2011; but in the meantime, "financings" were disguised as "true sales," permitting banks to grossly over-borrow and over-leverage. Over-leveraging allowed credit to be pumped up to bubble levels, driving up home prices. When the bubble collapsed, homeowners had to pick up the tab by paying on mortgages that far exceeded the market value of their homes. According to Whalen:

> [T]he largest commercial banks became "too big to fail" in large part because they used non-bank vehicles to increase leverage without disclosure or capital backing. . . .
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> The failure of Lehman Brothers, Bear Stearns and most notably Citigroup all were largely attributable to deliberate acts of securities fraud whereby assets were "sold" to investors via non-bank financial vehicles. These transactions were styled as "sales" in an effort to meet applicable accounting rules, but were in fact bank frauds that must, by GAAP and law applicable to non-banks since 1997, be reported as secured borrowings. Under legal tests stretching from 16th Century UK law to the Uniform Fraudulent Transfer Act of the 1980s, virtually none of the mortgage backed securities deals of the 2000s met the test of a true sale.
>
> . . . When the crisis hit, it suddenly became clear that the banks' capital was insufficient.
>
> Today . . . hundreds of billions in claims against banks arising from these purported "sales" of assets remain pending before the courts.

Eminent Domain as a Negotiating Tool

Investors can afford high-powered attorneys to bring investor class actions, but underwater and defaulting homeowners usually cannot; and that is where local government comes in. Eminent domain is a way to bring banks and investors to the bargaining table.

Professor Robert Hockett of Cornell University Law School is the author of the plan to use eminent domain to take underwater loans and write them down for homeowners. He writes on NewYorkFed.org:

> [In] the case of privately securitized mortgages, [principal] write-downs are almost impossible to carry out, since loan modifications on the scale necessitated by the housing market crash would require collective action by a multitude of geographically dispersed security holders. The solution . . . Is for state and municipal governments to use their eminent domain powers to buy up and restructure underwater mortgages, thereby sidestepping the need to coordinate action across large numbers of security holders.

The problem is blowback from the banks, but it can be blocked by requiring them to prove title to the properties. Securities are governed by federal law, but real estate law is the domain of the states. Counties have a mandate to maintain clean title records; and legally, clean title requires a chain of "wet" signatures, from A to B to C to D. If the chain is broken, title is clouded. Properties for which title cannot be established escheat (or revert) to the state by law, allowing the government to start fresh with clean title.

New York State law governs most of the trusts involved in securitization. Under it, transfers of mortgages into a trust after the cutoff date specified in the Pooling and Servicing Agreement (PSA) governing the trust are void.

For obscure reasons, the REMICs (Real Estate Mortgage Investment Conduits) claiming to own the properties routinely received them after the closing date specified in the PSAs. The late transfers were done throu gh the fraudulent signatures-after-the-fact called "robo-signing," which occurred so regularly that they were the basis of a $25 billion settlement between a coalition of state attorneys general and the five biggest mortgage servicers in February 2012. (Why all the robo-signing? Good question. See my earlier article here.)

Until recently, courts have precluded homeowners from raising the late transfers into the trust as a defense to foreclosure, because the homeowners were not parties to the PSAs. But in August 2013, in *Glaski v. Bank of America, N.A.*, 218 Cal. App. 4th 1079 (July 31, 2013), a California appellate court ruled that the question whether the loan ever made it into the asset pool could be raised in determining the proper party to initiate foreclosure. And whether or not the homeowner was a party to the PSA, the city and county have a clear legal interest in seeing that the PSA's terms were complied with, since the job of the county recorder is to maintain records establishing clean title.

Before the rise of mortgage securitization, any transfer of a note and deed needed to be recorded as a public record, to give notice of ownership and establish a "priority of liens." With securitization, a private database called MERS (Mortgage Electronic Registration Systems) circumvented this procedure by keeping the deeds as "nominee for the beneficiary," obscuring the property's legal owner and avoiding the expense of recording the transfer (usually about $30 each). Estimates are that untraceable property assignments concealed behind MERS may have cost counties nationwide billions of dollars in recording fees. (See my earlier article here.)

Counties thus have not only a fiduciary but a financial interest in establishing clean title to the properties in their jurisdictions. If no one can establish title, the properties escheat and can be claimed free and clear. Eminent domain can be a powerful tool for negotiating loan modifications on underwater mortgages; and if the banks cannot prove title, they have no standing to complain.

The End of "Too Big to Fail"?

Richmond's city council is only one vote short of the supermajority needed to pursue the eminent domain plan, and it is seeking partners in a Joint Powers Authority that will make the push much stronger. Grassroots efforts to pursue eminent domain are also underway in a number of other cities around the country. If Richmond pulls it off successfully, others will rush to follow.

The result could be costly for some very large banks, but they have brought it on themselves with shady dealings. Christopher Whalen predicts that the FDIC's withdrawal of "safe harbor" status for the securitization model may herald the end of "too big to fail" for those banks, which will no longer have the power to grossly over-leverage and may have to keep their loans on their books.

Wall Street banks are deemed "too big to fail" only because there is no viable alternative – but there could be. Local governments could form their own publicly-owned banks, on the model of the state-owned Bank of North Dakota. They could then put their revenues, their savings, and their newly-acquired real estate into those public utilities, to be used to generate interest-free credit for the local government (since it would own the bank) and low-cost credit for the local community. For more on this promising option, which has been or is being explored in almost half the state legislatures in the US, see here.

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