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The Give and Take of Liar Loans

By JOE NOCERA

Did you hear the one about Countrywide Financial demanding that mortgage originators buy back many of the so-called stated-income loans that it had purchased from them during the late great housing bubble?

It boggles the mind. This, after all, is Countrywide we're talking about: Countrywide, which came to represent, in the public mind, the dirtiest of all the subprime lenders. Countrywide, which handed out fraudulent stated-income loans — they were often called "liar loans" — like candy. Countrywide, whose former chief executive, the disgraced Angelo Mozilo, once actually admitted to analysts, "I believe there is a lot of fraud in stated-income loans."

This same company is now insisting that other lenders that made stated-income loans — loans that Countrywide eagerly bought to fatten its balance sheet — must repurchase them on the grounds that, golly, the loans turned out to be fraudulent. The hypocrisy is breathtaking.

At least, it is until you realize one other salient fact: since early 2008, Countrywide has been owned by Bank of America. Then it all starts to make some perverse sense.

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You know what a stated-income loan is, don't you? It is — or, rather, it was — a loan in which the borrower doesn't have to verify his or her income, but simply states it. (Not surprisingly, since the subprime bubble ended, stated-income loans have become pretty much extinct.) On the face of it, you would think that no lender in his or her right mind would accept an income figure based solely on the borrower's word. But you would be very, very wrong.

There actually is a tiny group of borrowers for whom a stated-income loan makes sense, and for whom the product was originally intended: someone with a large amount of income, but whose tax returns are so complex that it is difficult to calculate the person's effective income. A borrower who can make a down payment of, say, 35 or 40 percent, has a large stock portfolio and has a high credit score — that person is a good lending risk no matter his or her actual income.

But whenever lenders have stretched these loans beyond that very narrow category, bad things have resulted. In the 1980s, for instance, Citibank took a stated-income loan product that had had some moderate success in New York City and offered it to the rest of the country — then watched its default rate explode. It wound up not only withdrawing the product, but also indemnifying Fannie Mae and Freddie Mac, which had guaranteed many of the loans.

During the subprime madness earlier this decade, stated-income loans became the dominant feature of most subprime loans. Documenting income, after all, took time and effort, and who had time for it when everyone in the business was making subprime loans as fast as humanly possible? "Stated-income loans were viewed as relief from documentation," said Lou Barnes, the founder of Boulder West Financial Services. (Boulder West is now owned by the Premier Mortgage Group.)

Competitive pressures also prompted the growth of stated-income loans. With such loans so easy to get, mortgage originators that refused to make them began losing business to those, like Countrywide, that were only too happy to make them.

Finally — and perhaps most important — stated-income loans became a means for both borrowers and lenders to commit fraud. That may have been their greatest appeal. Real estate speculators used stated-income loans to buy properties that would otherwise have been out of reach, hoping to flip them quickly, before their lack of income caught up with them. Far more frequently, however, mortgage originators used stated-income loans to put people into homes that were far beyond their means, knowing full well that the chance of the borrower ever paying back the loan was practically nil.

As I mentioned in a column a few months ago, the Mortgage Guaranty Insurance Corporation — which is embroiled in litigation with (who else?) Countrywide over whether Mortgage Guaranty has to pay off insurance on stated-income loans that went bad — hired investigators to root out some examples of fraud. To take just one example alleged in the document: a self-described dairy foreman who listed his monthly income as $10,500 was actually a dairy milker making a tenth of that amount. The mortgage broker was completely aware of this fraud, according to the complaint. Nonetheless, the borrower got a $350,000 mortgage.

The complaint by Mortgage Guaranty reads: "By about 2006, Countrywide's internal risk assessors knew that in a substantial number of its stated-income loans — fully a third — borrowers overstated income by more than 50 percent." The complaint adds, "Countrywide deliberately disregarded these and other signs of fraud in order to increase its market share."

Today, the drunken revelry that was the subprime mortgage bubble has resulted in billions of dollars in losses from all those fraudulent loans. Fannie Mae and Freddie Mac both bought and guaranteed stated-income loans. Wall Street underwrote mortgage-backed securities and collateralized debt obligations stuffed with stated-income loans. Investors bought those securities because they were promised high yields and, thanks to the absurd triple-A ratings on the securities, very little risk. Insurance companies like M.G.I.C. insured stated-income loans. And big banks and mortgage originators — Countrywide, especially — kept at least some stated-income loans on their books in an effort to bolster their own yields.

For the country, the impact of stated-income loans has been terrible. Now, with the memory of their lax underwriting still fresh in their minds, bankers have been demanding document upon document, proof upon proof, for anybody wanting to buy a home. People who would have been considered perfectly acceptable borrowers before the bubble can't get a loan in this new world. It is one of the big reasons the housing market remains depressed.

For the companies involved, the overhang from stated-income loans has resulted in an enormous catfight, as each participant tries to force someone else to absorb the majority of the losses. Hence the squabbling over something called "reps and warranties." As the loans were sold from one entity to another during the bubble, contractual language was written that allowed the buyer to force the seller to repurchase the loan under certain conditions. Evidence of fraud is one such condition. Now, every participant in the marketplace is trying to use that contractual language to force another of the participants to swallow losses.

Take, for instance, that litigation between Countrywide and the Mortgage Guaranty Insurance Corporation. For some time now, the mortgage insurer has refused to pay claims on thousands of stated-income loans it insured, on the unsurprising grounds that the loans were fraudulent at their inception and thus violated the terms under which the company insured them. In December, Bank of America filed suit on behalf of its Countrywide unit, arguing, in effect, that it doesn't matter whether the loans were fraudulent. Since the insurer never asked for income verification — and accepted the fact they were stated-income loans — it has to pay up. (Nearly a year later, the litigation is just getting started.)

Now contrast that stance with Countrywide's effort to force smaller mortgage originators to buy back loans it had purchased. In these cases, Countrywide makes the exact opposite argument: because the loans were made fraudulently, the smaller companies have an obligation to buy them back. Never mind that Countrywide, just like Mortgage Guaranty, made no effort to verify the income and undoubtedly knew the loans were fraudulent. Heck, everybody knew that many of these loans were fraudulent.

Thus, when it serves Countrywide's purposes to argue that everyone knew the loans were fraudulent, it happily makes that case. But when it is better served by arguing that it is shocked — shocked! — to discover gambling in the casino, it makes that opposing argument with similar ease. Isn’t that the dictionary definition of hypocrisy?

When I brought this up with several Bank of America spokesmen this week, they were offended at my characterization. “We have bought back billions of loans that we found justified,” said James Mahoney, a company spokesman. “We will continue to buy back loans when justified.” He pointed, for instance, to the more than $5 billion in bad loans the bank had repurchased from Fannie Mae and Freddie Mac.

The bank is right, up to a point. It is repurchasing many of the loans Fannie and Freddie guaranteed for Countrywide. But that is in part because not even Bank of America can afford to anger Fannie and Freddie, which are the lifeblood of the mortgage industry right now. (It is also because Fannie and Freddie have much tougher contractual language than most private underwriters use.) If Fannie and Freddie were to, say, stop guaranteeing Bank of America’s mortgages, the bank would be out of the mortgage business.

In the cases of investors and insurers like Mortgage Guaranty, Bank of America is taking a much tougher line. Yes, it is buying back loans, but it is also engaged in something more akin to hand-to-hand combat, fighting over each and every loan, and repurchasing them only when the evidence of fraud is so strong that it has no other choice but to take them back.

As for those smaller mortgage originators I began this column with, they are in the opposite position from Fannie and Freddie. They need Bank of America a lot more than Bank of America needs them. So they are swallowing hard and buying back the loans they once sold to Countrywide. They don’t have a lot of choice.

So I take it back. “Hypocrisy” is probably the wrong word. All Bank of America is really doing is talking out of both sides of its mouth, using whichever argument it finds most convenient. So maybe a better word to describe the bank’s actions would be “chutzpah.”

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