Feds Stepping Up Scrutiny As Falling Property Values Expose Fraud

By Matt Wasielewski

Federal prosecutors and regulators are tracking a noticeable uptick in falsified financial reporting on loan documents from the mid-2010s through 2021, The Wall Street Journal reports. Rising interest rates have left many of the landlords at those properties struggling to stay afloat, exposing their schemes and leaving them open to prosecution.

"It's a general trend throughout history that fraud occurs during boom times and is revealed during bust times," John Griffin, a professor of finance at the University of Texas, told the WSJ.

The role of property appraisals is at the core of the financial malfeasance. Lenders typically accept valuations presented by reputable developers and landlords, trusting the numbers to be accurate, industry professionals told the WSJ.

Reporting deflated costs and inflated revenue through rents, for example, can secure better loan terms or higher dollar values. When rates are low, those loans can perform, but as rates rise, actual rents don't go as far to cover interest expenses.

Lenders aren't incentivized to scrutinize landlords' financial documents because the bigger the loans they hand out, the more money in fees they can bring in when they securitize the debt.

Federal prosecutors are boosting their efforts to expose fraud, according to the WSJ, often with cooperation from the Federal Housing Finance Agency, which oversees Freddie Mac and Fannie Mae.

Cumulative data isn't publicly available, but at least five landlords have pleaded guilty to federal fraud charges since last fall, the WSJ reported. Some were accused of doctoring income statements, while others allegedly faked property sales to inflate prices and secure a larger loan.

Fannie Mae and Freddie Mac have taken measures to identify and investigate fraud.

Freddie Mac rolled out new policies in April to detect fraud and mitigate risk, adjusting its due diligence and Know Your Customer requirements. It also strengthened its appraisal review independence requirements to safeguard the "objectivity and impartiality of appraisers."

The move came about six months after Fannie Mae changed its policies to increase scrutiny for all broker-involved agency loans, causing some loan requests to need resubmitting for additional review.

Both lenders have also stopped accepting loans from New York-based Meridian Capital Group, one of the country's largest brokers of commercial mortgages, as Freddie Mac conducts a widening investigation into some brokers potentially falsifying information to secure larger loans.

Boruch Drillman, a New York developer, pleaded guilty to a $165M mortgage fraud conspiracy in December in one of the highest-profile recent cases. The scheme involved the use of stolen identities to create fake purchase and sale contracts and fraudulent letters of intent for purchases that were presented to appraisers to boost valuations.

Two title insurers, Riverside Abstract and Madison Title Agency, were also blacklisted by Fannie Mae as it investigates work the firms did for Drillman.

Freddie Mac has also stopped accepting new loans with valuations from BBG, one of the country's largest appraisal firms, as the lender conducts a review of the firm.

In another case, investor Aron Puretz pleaded guilty last month to a $54.7M mortgage fraud conspiracy. He admitted to faking financial statements to secure multifamily and commercial loans from Freddie Mac and other lenders.

The problem of overvaluation in loans could be more widespread, Griffin told the WSJ.

In a 2023 paper, he and co-author Alex Priest studied more than 30,000 commercial mortgages repackaged into bonds and found that nearly a third of the loans were underwritten with reported profits at least 5% above their actual operating profit.