

Occupancy Fraud in Mortgages Is Rampant. 1 in 3 Investors Are Liar Loans



You can't open the paper these days with a story on occupancy fraud. In fact, politicians across the US are being accused of lying to mortgage lenders about their intention to live in a property.

But it's a fraud that has been around for years and it's surprisingly common.

A comprehensive Federal Reserve Bank of Philadelphia analysis examining nearly 600,000 mortgages found that roughly one-third of all real estate investors lie about living in the homes they buy.

How Occupancy Liar Loans Work

Occupancy fraud happens when a homeowner lies about their intention to live in a property during a mortgage application.

In most cases they claim that a property will be their primary residence when it's a second home or investment property .

By posing as an owner-occupant, the borrower will get a big discount on their interest rate because Fannie and Freddie believe they are less risky .

If they were to claim for example that the property was a second homes the interest rates will be 0.25–0.5% higher and if they claim it's an investment property, the interest rate will be 0.5–1.0%.

One In Every Three Investors Are Liars

In January 2023, researchers at the Federal Reserve Bank of Philadelphia published a comprehensive analysis of occupancy fraud, titled "*Owner-Occupancy Fraud and Mortgage Performance.*"

The report found that at the height of the housing boom in 2006, more than 7 percent of all homebuyers were secretly investors pretending to be regular families moving into new homes. Even after the financial crisis supposedly cleaned up mortgage lending, the problem persisted and actually got worse.

By 2010, they determined that 33% of all real estate investors were misstating their occupancy status to get better terms . This means the true scale of investor activity in the mortgage market was about 50% higher than official loan data suggested

Default Rates Are 75% Higher When Occupancy Fraud Is Involved

The real danger with occupancy fraud emerges when housing markets weaken. Loans involving occupancy fraud default at rates 75 percent higher than comparable mortgages to declared investors.

Because borrowers that misrepresented their occupancy were allowed to take larger loans, they accounted for an outsized share of credit losses – fraudulent loans made up under 4% of the mortgages studied but over 11% of the total dollars in default according to the study.

Once home values dropped putting investors underwater, they strategically defaulted and cut their losses, leaving lenders and taxpayers and Fannie and Freddie holding the bag.

The Accidental Fraud? Not Really

Lisa Cook, the most recent politician accused of occupancy fraud, claims that it was an administrative or accidental error.

The researchers looked into this very scenario. They researched whether some borrowers might have fallen into fraud accidentally, perhaps buying a new home before selling an old one.

They found that there was little evidence that this happens.

The study found little evidence that innocent explanations could account for many of the misrepresentations. In most cases, the data indicated intentional misreporting rather than happenstance. This reinforces the fact that occupancy fraud is mostly deliberate to game the system.

Why Can't Fannie and Freddie Stop This Fraud?

With occupancy fraud running so rampant, why can't Fannie and Freddie get a handle on this scheme?

While 33% of investors appear to commit this fraud, the agencies rarely ever require lenders to repurchase loans where occupancy fraud is involved.

But, according to a recent Wall Street Journal only about 1 in 400 single-family mortgages is ever required to be repurchased by the lender. This is an extremely

low rate (0.25%), meaning that either very few defects are being found or that many are overlooked/waived.

The Philadelphia Fed findings seem to suggest it's the latter. Fannie and Freddie are selectively looking for this fraud when it **a)** defaults and they want to get rid of the loan, or **b)** when it suits them to find it.

In either case there is a ton of opportunity here.