

## **Chapter 12**

### **The financial crisis and mortgage fraud: the unforeseen circumstances of the war on terrorism and the financial war on terrorism, a critical reflection**

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#### **Abstract**

The article illustrates how the instigation of the ‘War on Terrorism’ and the ‘Financial War on Terrorism’ had a catastrophic impact on the ability of the Federal Bureau of Investigation to tackle mortgage fraud that was associated with the 2007/2008 financial crisis. Initially, the article identifies and demonstrates how President George Bush decided to prioritise tackling terrorism and the financing of terrorism following the al Qaeda terrorist attacks on September 11 2001. This was illustrated by the creation of the Department of Homeland Security in 2002, the extension of the remit of the Department of Justice and the redistribution of specialist white collar crime agents from the Federal Bureau of Investigation to enforce terrorist related legislation. The second part of the article illustrates the association between the financial crisis, subprime mortgages and mortgage fraud. The article then moves on to critically review the impact of the alteration in policy towards mortgage fraud that was introduced by President Barak Obama in 2009. Therefore, questioning the effectiveness of the policies adopted by President George Bush.

## 1. Introduction

The 2007/2008 financial crisis has attracted a great deal of research, debate and conjecture on the identification of its contributory factors. Many government commissioned reports have attempted to identify the root-causes of the financial crisis and have ascertained an embarrassment of complex and interwoven financial, legislative and regulatory factors that contributed to the largest financial collapse since the Wall Street Crash in 1929. For example, the United States (US) Financial Crisis Inquiry Commission Report (Financial Crisis Commission) concluded that there were several factors that caused the financial crisis. This included weak financial regulation, the collapse of corporate governance and risk management, unwarranted borrowing combined with precarious investments, ill-equipped governments, a complete break down of accountability and ethics, collapsing mortgage lending standards, mortgage securitization, over-the-counter derivatives and the failures of Credit Rating Agencies (Financial Crisis Enquiry Report, 2011, p. xv-xxviii). Additionally, the US Department of Treasury (2008) stated that there were five elements: a complete breakdown in underwriting standards for subprime mortgages; a significant erosion of market discipline; flaws in CRAs; risk management weaknesses at many large financial institutions and ineffective banking regulation. The Federal Reserve identified more components that included a generalized run on global financial institutions; the dependence of many financial systems on short-term funding; a vicious cycle of market-to-market losses driving fire sales of asset backed securities; the realization that financial firms were pursuing flawed business models and were subject to similar risks and global swings in risk aversion supported by instantaneous worldwide communications and a shared business culture (2010, p. 6). In the United Kingdom (UK), the Financial Services Authority (FSA) concluded that “the origins of the greatest post-war financial crisis can be traced back to a combination of macroeconomic factors and financial market developments. The resulting exuberance in pricing credit and volatility risk developed into a self-reinforcing cycle, exacerbated by a failure to develop appropriate macro-prudential policy responses” (FSA, 2009, p. 5). In particular, the FSA identified six factors that included the macroeconomic imbalances increasing the complexity of the securitised credit model; the rapid extension of credit and falling credit standards; the property price boom; increasing leverage in the banking and shadow banking system; underestimation of bank and market liquidity risk, and self-reinforcing cycle of irrational exuberance (ibid, p. 7-12). Other well documented influences that triggered the financial crisis included the spectacular collapse of the US subprime mortgage sector (European

Commission, 2009), weak and ineffective banking regulation models (Hutchins, 2011, p. 293), high levels of consumer debt and related over-indebtedness (Dickerson, 2009, p. 395), the sale of toxic debts (Arsalidou, 2010, p. 284), securitisation (Nwogugu, 2008, p. 316), deregulation of banking legislation (Levitin, 2009, p. 399), ineffective macroeconomic policies (Gevurtz, 2010, p. 113), weak consumer credit regulation (Schaefer, 2012, p. 741), the deregulation of consumer credit legislation (Choi and Papaioannou, 2010, p. 442) and the culture of some banking practices (Tomasic, 2011, p. 7). However, one of the most significant developments in the aftermath of the financial crisis has been the increasing recognition that white collar crime either triggered the financial crisis or was a significant contributory factor (Ryder, 2014; Huisman, 2012; Deflem, 2011; Herlin-Karnell, 2012; Hardouin, 2011; Creseney et al., 2009; Eng and Nuttal, 2009; Posner and Vermeule, 2009). It is not the purpose of this article to identify the different types of white collar crime that caused the financial crisis, instead, it will uniquely concentrate on how the instigation of the 'War on Terrorism' and the 'Financial War on Terrorism' contributed towards the inability of US authorities to tackle the most prominent type of white collar crime to be associated with the financial crisis, mortgage fraud. The article begins by providing a brief overview of the instigation of the 'War on Terrorism' and the 'Financial War on Terrorism' by President George Bush, in September 2001. It then outlines and highlights how the al Qaeda terrorist attacks resulted in the transformation of the US white collar crime strategies to include the ill-considered merger between its anti-money laundering (AML) and counter-terrorist financing (CTF) strategies, and how this metamorphosis had a catastrophic impact on their ability to tackle mortgage fraud. The next section of the article illustrates the link between the financial crisis, subprime mortgages and mortgage fraud before moving to identify and critically considering the impact of the alteration in policy towards mortgage fraud that was introduced by President Barak Obama.

## **2. The war on terrorism and the financial war on terrorism**

It is the hypothesis of this article that an unforeseen factor that contributed towards the financial crisis was the instigation of the 'War on Terrorism' and the 'Financial War on Terrorism'. Both of these were introduced by President George Bush following the terrorist attacks in September 2001. It has been suggested that the President associated the 'War on Drugs' with the 'War on Terrorism' after it was insinuated that the terrorist attacks in 2001 were partly financed by the profits of sale of illegal narcotics (Kenney, 2003, p. 187). On

September 15 2001 President George Bush declared that the US was at ‘war’ and on September 18 Congress permitted the President to “use all necessary and appropriate force against those nations, organisations, or persons he determines planned, authorised, committed, or aided the terrorist attacks ... or harboured such organisations or persons, in order to prevent any future acts of international terrorism against the United States” (Public Law 107–40). The ‘War on Terrorism’ began on October 7 2001 when UK and US forces conducted the first of many aerials bombardments of selected al Qaeda and Taliban targets in Afghanistan (The White House, 2001a). These attacks were soon followed in January 2002 by the deployment the NATO led International Security Assistance Force, who became involved in armed conflict with the Taliban and al-Qaeda. The US ended its use of the phrase ‘War on Terrorism’ in April 2009, when the Department of Defence replaced it with ‘Overseas Contingency Operations’ (United States Government Accountability Office, 2009). It has been suggested that President Barak Obama declared an end to the ‘War on Terrorism’ in a speech in May 2013 when he stated that “every war has come to an end ... we must define our effort not as a boundless ‘global war on terror’, but rather as a series of persistent, targeted efforts to dismantle specific networks of violent extremists that threaten America” (The White House, 2013). However, the Director of the Central Intelligence Agency, John Brennan, stated in 2015 that the ‘War on Terrorism’ would never end:

If we were not as engaged against the terrorists, I think we would be facing a horrendous, horrendous environment ... it’s a long war, unfortunately. But it’s been a war that has been in existence for millennia ... so this is going to be something, I think, that we’re always going to have to be vigilant about (Harvard University, 2015).

The most significant part of the US response to the terrorist attacks in September 2001 that would have a catastrophic effect on its ability to tackle mortgage fraud was the decision to pursue the development and implementation of a national strategy for homeland security. This was propelled by the announcement in 2002 for the creation of the Department of Homeland Security. In June 2002 President George Bush declared that his most important responsibility was to “protect and defend the American people” (Department of Homeland Security, 2002, p. 2). The Department of Homeland Security stated that “the President proposes to create a new Department of Homeland Security, the most significant transformation of the US government in over half a century by largely transforming and realigning the current confusing patchwork of government activities into a single department

whose primary mission is to protect our homeland” (ibid). The Department of Homeland Security was established via the Homeland Security Act 2002 (Public Law 107-296, November 25, 2002), and its creation has been described as the biggest “reorganization of the federal government since World War II” (Thomson, 2010, p. 277). When the Department of Homeland Security was launched in March 2003, it represented the merger and integration of 22 different government agencies and departments. Indeed, it has been suggested that prior its creation, there were over 100 government organisations that were undertaking the responsibilities of the Department of Homeland Security (Department of Homeland Security, 2002). The Homeland Security Act provides the Department of Homeland Security with three objectives including the prevention of terrorist attacks (Home Land Security Act 2002, s. 101(b)(1)(a)), to reduce the vulnerability of the US to terrorism (Home Land Security Act 2002, s. 101(b)(1)(b)) and to minimize the damage and help in the recovery from terrorist attacks (Home Land Security Act 2002, s. 101(b)(1)(c)). In order to achieve these objectives, the Department for Homeland Security was given a considerable annual budget and an extensive array rulemaking powers. For example, in 2002 the budget was \$19.5bn (Department of Homeland Security, 2003, p. 9), \$37.7bn in 2003 (ibid), \$36.2bn in 2004 (Department of Homeland Security, 2004 p. 1), \$40.2bn in 2005 (Department of Homeland Security, 2005, p. 3), \$41.1bn in 2006 (Department of Homeland Security, 2006, p. 5), \$42.7bn in 2007 (Department of Homeland Security, 2007, p. 5), \$46.4bn in 2008 and (Department of Homeland Security, 2008, p. 7) \$50.5bn in 2009 (Department of Homeland Security, 2009, p. 7). At the time of writing this article the proposed annual budget is \$41.2bn (Department of Homeland Security, 2015, p. 10). The Department for Homeland Security is able to perform its duties by issuing regulations under its six operational components which includes the US Citizenship and Immigration Services, the US Coast Guard, the US Customs and Border Protection, the Federal Emergency Management Agency, US Immigration and Customs Enforcement and the Transportation Security Administration. The creation of the Department of Homeland Security and the prevention of terrorism became the top priority for the Bush Administration and resulted in sweeping changes to how the Federal Bureau of Investigation (FBI) tackled white collar crime, and in particular mortgage fraud. The impact of this policy change following the terrorist attacks in September 2001 will be further explored and analysed in a later section of this article, but it now turns its attention to how the ‘Financial War on Terrorism’ also contributed towards the inability of the US to tackle mortgage fraud.

On September 24 2001, President George Bush famously declared “we will starve terrorists of funding, turn them against each other, rout them out of their safe hiding places, and bring them to justice” (The White House, 2001b). The ‘Financial War on Terrorism’ had begun, and this announcement was followed by frequent declarations of the freezing of the financial assets of terrorists and their supporters. The ‘Financial War on Terrorism’ resulted in a seismic shift in the white collar crime strategies of the international community away from money laundering towards the financing of terrorism (Harrison and Ryder, 2013, p. 39). This is a view strongly asserted by Alexander who stated that “terrorist financing only became of international concern following the al Qaeda attacks” (2003, p. 200). Therefore, as argued by Eckert, “the events of 11 September precipitated a sea change in the manner with which regulators and financial institutions approached the issue of terrorist financing” (2008, p. 229). Until the terrorist attacks in September 2001, the international community had directed its resources and legislative provisions towards tackling the proceeds of drug related crimes, a point clearly illustrated by the remit of the United Nations (UN) Convention against Narcotic and Psychotropic Substances, the early AML legislative measures introduced by the European Union (EU) and the scope of the 40 Recommendations of the Financial Action Task Force (FATF). The international community responded to the declaration by President George Bush and introduced a series of CTF legislative provisions. However, it is essential to note that the foundations of the ‘Financial War on Terrorism’ were contained in the 1999 International Convention for the Suppression of the Financing of Terrorism, before the terrorist attacks in 2001 (54/109 of December 9 1999). The aim of the International Convention was to “enhance international co-operation among States in devising and adopting effective measures for the prevention of the financing of terrorism” (Abeyratne, 2011, p. 57). It is important to note that prior to the terrorist attacks, “only four States had acceded to the Convention” (O’Neill, 2012, p. 31). However, at the time of writing the International Convention has been implemented by 186 nation states. Terrorist financing was defined by the International Convention as including “assets of every kind, whether tangible or intangible, movable or immovable, however acquired, and legal documents or instruments in any form” (International Convention for the Suppression of the Financing of Terrorism (1999) Art.1 para.1). Terrorist financing has also been referred to as ‘reverse money laundering’, which is a practice whereby ‘clean’ or ‘legitimate’ money is acquired and then funnelled to support acts terrorism. Supplementary, the UN issued Security Council Resolution 1267 in 1999, which generated a sanctions regime that applied to people or entities that were associated with the Taliban, Osama bin Laden and al-Qaida (United

Nations, 1999). This was followed by fulcrum of the ‘Financial War on Terror’, UN Security Council Resolution 1373, which was unanimously adopted by UN on September 20 2001 (United Nations, 2001). The scope and remit of Security Council Resolution 1373 has been amended by Resolutions 1390 (United Nations, 2002), 1456 (United Nations, 2003) and 1566 (United Nations, 2004).

Additionally, the EU “adopted a framework decision on combating terrorism” (Brunt, 2008, p. 114). For example, in December 2001, the European Council adopted the Common Position on combating terrorism, which was the legal instrument that implemented UN Security Council Resolution 1373 ([2002] OJ L164/3). Furthermore, Council Resolution 2580/2001 required members of the EU to freeze the funds, financial assets and resources of people and named groups ([2001] OJ L344/93). Additionally, Council Resolution 881/2002 included a ‘black list’ of names that were identical to the list determined by the UN Sanctions Committee. The Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime and on the Financing of Terrorism was authorised in December 2005 in Warsaw (Abeyratne, 2011, p. 57). Importantly, the 2005 the Convention amended the scope of the 1990 Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime to include the financing of terrorism (European Commission, 2005). However, it is important to note that prior to the terrorist attacks in September 2001, the EU had directed its white collar crime efforts on money laundering and not the financing of terrorism, thus adopting an identical stance to that of the UN. For example, the EU has implemented three Money Laundering Directives, the first of which concentrated on the tackling the laundering of the proceeds of drug trafficking through the financial system, and not the financing of terrorism (Council Directive 91/308/EEC). At the start of the new Millennium it became clear that the scope of the First Directive was too narrow and ineffective (Mitsilegas and Gimlore, 2007, p. 119). Therefore, the EU introduced a broader Second Money Laundering Directive (Directive 2001/97/EC) which increased the list of predicate offences for which the suspicious transaction reports were compulsory from just drug trafficking offences to all serious criminal offences and extended the scope of the Directive to a number of professions and non-financial activities. However, the Second Money Laundering Directive did not include the financing of terrorism. In 2004, the European Commission determined that it was necessary to introduce a Third Money Laundering Directive, which included the financing of terrorism (Directive 2005/60/EC). The European Commission published a Fourth Draft Money Laundering Directive in February 2014, the

terms of which were agreed and approved by the European Council in February 2015 and it took effect from June 26 2015. Member States of the EU are required to implement the Directive by 2017 (The Law Society, 2015).

These legislative measures are supported by the expansion of the remit of the FATF to include the financing of terrorism in October 2001. The FATF was originally mandated to focus on the prevention of money laundering and this was evident by the publication and scope of its '40 Recommendations' (Financial Action Task Force, 2003). In October 2001, the FATF broadened its remit and included, at the time, an additional 'Eight Special Recommendations' to tackle terrorist financing. This was extended to the 'Nine Special Recommendations' and resulted in the Recommendations becoming referred to as the '40+9 Recommendations' (Sykes, 2007, p. 236). The objectives of the 'Special Recommendations' were to "detect, prevent and suppress the financing of terrorism and terrorist acts" (Financial Action Task Force, 2001, p. 2). These were further amended in February 2012 and are now referred to as the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation (Financial Action Task Force, 2012). Therefore, the extension of the remit of the international legislative measures to tackle the financing of terrorism would have both a long-term and fundamental impact on the white collar crime strategies of nation states. The next section of the article demonstrates the evolution of the US CTF legislation and how they were mistakenly based on its existing AML measures. It then moves on to explain how this would limit efforts to tackle mortgage fraud associated with the financial crisis in the US.

### **3. The evolution of the US counter-terrorist financing strategy**

It is important to note that prior to the terrorist attacks in September 2001, the US had concentrated its white collar crime resources on fraud and money laundering. For example, a wide range of fraudulent activities were originally criminalised by the Mail Fraud Statute in 1872 (18 U.S.C. Chapter 63). This was followed by a glut of fraud related legislation including the Wire Fraud Statute 1952 (18 U.S.C. § 1341), the Comprehensive Crime Control Act 1984 (Public Law 98-473, S. 1762, 98 Stat. 1976, enacted October 12, 1984), the Major Fraud Act 1988 (Public Law 100-700), the Financial Institutions Reform and Recovery Act 1989 (Public Law 101-73), the Sarbanes-Oxley Act 2002 (Public Law 107-204) and the Fraud Enforcement and Recovery Act 2009 (Pub.L. 111-21, S. 386, 123 Stat. 1617). The US



AML policy originated in the 1960s when it's Department of Treasury became alarmed at the link between criminal behaviour and offshore bank accounts (Doyle, 2002, p. 279). The legislation that has become inherently associated with the US AML policy is the Currency and Foreign Transactions Reporting Act 1970, or as it is more commonly referred to the Bank Secrecy Act 1970 (Pub, L. 91-507-OCT. 26, 1970). The Bank Secrecy Act (BSA 1970) imposed a plethora of reporting obligations on a wide range of financial institutions, including currency transaction reports. The next notable development in the evolution of the US AML policy was its association with the 'War on Drugs' in the 1970s and 1980s (Ryder, 2012, p. 2). The AML policy was largely supported by a series of legislative measures that criminalised money laundering, expanded the scope of US forfeiture powers, expanded the currency transaction reporting requirements of the Bank Secrecy Act 1970 and introduced the use of suspicious activity reports (SARs). These legislative measures included the Money Laundering Control Act 1986 (Public Law 99-570), the Anti-Drug Abuse Act 1988 (Public Law 100-690), the Anti-Money Laundering Act 1992 (Public Law 102-276) and the Money Laundering Suppression Act 1994 (Public Law 99-570).

There are three legislative provisions that the US CTF legislative and regulatory framework is constructed on: the Trading with the Enemy Act 1917, Anti-terrorism and Effective Death Penalty Act 1996 and the Bank Secrecy Act 1970 (Donohue, 2008, p. 147). The Trading with the Enemy Act 1917 (12 U.S.C. §§ 95a–95b) provides the US President with the power to supervise and/or constrain trade between the US and its enemies in times of war. Additionally, the Trading with the Enemy Act 1917 criminalises conduct for any person in the US to trade with an enemy nation state (Aufhauser, 2009, p. 22). Therefore, the overarching aim of the 1917 Act is to enable to US to “exert control over financial transactions or impose sanctions against foreign countries and/or nationals” (Savage, 2001, p. 21). The second piece of legislation was the Anti-terrorism and Effective Death Penalty Act 1996 (Pub. L. No. 104-132, 110 Stat. 1214). The purpose of the 1996 Act is to enable the US government “to prevent persons within the United States ... from providing material support or resources to foreign organizations that engage in terrorist activities” (ibid). The Act was signed in April 1996, a year after the bombing of the Oklahoma City federal building by Timothy McVeigh. The legislation contained two important statutory provisions that permitted the victims of terrorism to sue to state sponsors of terrorism and prohibited fund raising in the US by terrorist groups (§ 303(a), 110 Stat. at 1250). The aim of the Anti-terrorism and Effective Death Penalty Act 1996 was to “hold terrorist nations accountable

and to create a civil remedy for victims of foreign terrorism” (Conway, 2002, p. 735). Furthermore, the Anti-terrorism and Effective Death Penalty Act 1996 amended the foreign state immunity provisions of the Foreign Sovereign Immunities Act 1976. By virtue of the 1996 Act, the US government is authorised to designate an organisation as a foreign terrorist organisation if they determine that “(a) the organization is a foreign organization (b) the organization engages in terrorist activity ... (c) the terrorist activity or terrorism of the organization threatens the security of United States nationals or the national security of the United States” (8 U.S.C. §1189(a)(1) (Supp. IV 1998). Additionally, the Anti-terrorism and Effective Death Penalty Act 1996 “created two lists of entities against which financial structures applied: state sponsors of terrorism and designated foreign terrorist organisations” (Donohue, 2008, p. 148). The first list was created under the International Emergency Economic Powers Act 1977 and the second by designation of foreign terrorist organisations (See 50 U.S.C. § 1702(a)(1)(B)). The aim of the legislation was to provide “the President authority in national emergency situations to prohibit dealings by any person subject to the jurisdiction of the United States with designated foreign persons and parties” (Kelley, 1992, p. 167). The powers under the 1977 Act have been used against several countries including Libya, Iraq, Haiti, Iran South Africa, Nicaragua, Panama and Kuwait (ibid, p. 173). Indeed, it has been argued that these powers have been used to deal with a wide range of matters including “national emergencies as the Iranian hostage seizure, Sandinista activities in Nicaragua, apartheid in South Africa, terrorist activities in Libya, Iraq’s invasion of Kuwait, and the crisis in Haiti” (Gantz, 1995, p. 1). The International Emergency Powers Act 1977 has been described as “one of the primary tools used in fighting the financial war on terror. Although the [Act] ... existed prior to the terrorist attacks of September 11 ... it provides the legal framework to block assets of organizations that are deemed to be aiding and abetting foreign terrorist groups” (Ferrari, 2005, p. 205). The second type of terrorist related list was introduced by the Anti-terrorism and Effective Death Penalty Act 1996 (Donohue, 2008, p. 149). Warneck took the view that the 1996 Act “prevents funds from ever reaching the organization by ... forbidding contributions to groups that the Secretary of State has classified as terrorist organizations” (1998, p. 177). The powers under the Anti-terrorism and Effective Death Penalty Act 1996 was first utilised in October 1997 by the then Secretary of State Madeline Albright (Department of State, 1997). Under this legislation, it is possible for the US government to designate individuals and groups as foreign terrorist organisations. Specifically, the 1996 Act permits the Secretary of State, to liaise with the Secretary of the Treasury to “designate an organisation as a foreign terrorist organisation” (8 U.S.C.

§1189(a)(1) (Supp. IV 1998)). It is possible for a body that has been designated as a foreign terrorist organisation to challenge this description within thirty days of its publication in the Federal Register (8 U.S.C. § 1189(6)(c)(1)). The final area of legislation was the BSA 1970, which “focused on creating a paper trail to help the state detect an investigate violations of tax and criminal law” (Donohue, 2008, p. 151).

It is important to note that from the early AML measures spawned the untimely and ill-advised merger of the US AML and CTF strategies by virtue of the Money Laundering and Financial Crimes Act 1998. This legislation required the US government to publish and deliver its National Money Laundering Strategy and also to “coordinate the efforts of law enforcement agencies and financial regulators in combating money laundering” (General Accounting Office, 2003, p. 1). Under the Act (31 USC § 5341(a)(1)–(2)), the Department of Treasury and the Department of Justice were required to produce five reports, which have yielded the publication of five National Money Laundering Strategies (Department of Treasury, 1999; Department of Treasury, 2001: Department of Treasury, Department of Treasury, 2003). The final National Money Laundering Strategy was published in 2007, (Department of Treasury, 2007) as a direct response to the publication of the Money Laundering Threat Assessment (Department of Treasury, 2005). The extension of the money laundering legislative framework to include terrorist financing must be questioned because the ‘AML model’ is based on tackling the proceeds or profits of criminal activity, where acts of terrorism do not generate a profit. The financial process adopted by terrorists to accumulate funds can be contrasted with that adopted by money launderers. For instance, terrorist financing has been referred to as ‘reverse money laundering’, which is a practice whereby ‘clean’ or ‘legitimate’ money is acquired and then funnelled to support terrorism (Ryder, 2013, p. 767). Conversely, money laundering involves the conversion of ‘dirty’ or ‘illegal’ money into clean money via its laundering through three recognised phases. The extension of the money laundering model to include terrorism must be queried because terrorism is not a profit based crime

The first part of the article has discussed the impact of the ‘War on Terrorism’ and the ‘Financial War on Terrorism’ on US white collar crime strategies. The creation of the Department of Homeland Security resulted in an unprecedented reorganisation of how US authorities tackled terrorism, with approximately 40 percent of its special agents being reassigned to protect homeland security. Ultimately, this decision would cripple the FBI’s

counter mortgage fraud efforts in the build-up to and during the financial crisis. The second section of the article moves on to highlight the link between the financial crisis and mortgage fraud.

#### **4. The financial crisis and mortgage fraud**

The origins of the financial crisis can be traced to the collapse of the US subprime mortgage sector in 2007 (Financial Crisis Enquiry Report, 2011). A subprime mortgage has been defined as a “non-traditional, higher risk loans that frequently carry above market interest rates” (Slevin, 2007, p. 18). Many commentators have concluded that the collapse of the US subprime mortgage market contributed towards the financial crisis (Singh and LaBrosse, 2010, p. 55). The spectacular collapse resulted in financial institutions reporting record losses (International Monetary Fund, 2010, p. 10), a large number of corporate insolvencies, significant losses for investors and banks (Wen, 2011, p. 325), record number of property repossessions (Marshall, 2009, p. 2) and record levels of consumer debt (Ruben, 2009). Additionally, several studies have determined that the collapse of the US subprime mortgage sector highlighted an underlying association with mortgage fraud. For example, Nguyen and Pontell stated that their “investigations have found that the growth of nonprime lending attracted a great deal of [mortgage] fraud” (2011, p. 12). These authors cited research by Black (2010) and Costello et al. (2007) which “found that fraudulent misrepresentation existing in almost every [mortgage application] file” (Nguyen and Pontell, 2011, p. 12). These studies were supported by the Federal Financial Institutions Examinations Council who stated that “industry experts estimate that up to 10% of all residential loan applications have some form of material misrepresentation, both inadvertent and malicious” (2009). The FBI stated that during the subprime mortgage crisis “mortgage fraud perpetrators ... [took] advantage of industry personnel attempting to generate loans to maintain current standards of living” (2004). Therefore, the FBI concluded that the “subprime mortgage issues remain a key factor in influencing mortgage fraud directly and indirectly” (ibid). This is a view supported by McCann who noted that “mortgage fraud perpetrated by these unregulated private mortgage brokers may have contributed to the instability and loss in the residential lending market that contributed to the mortgage crisis” (2010, p. 352). Therefore, mortgage fraud became the most prominent white collar crime to be associated with the financial crisis. It has been described as “the fastest growing white collar crime in the US” (FBI, 2006) and “one of the most pervasive problems in lending” (Jacobus, 2008, p. 188). Mortgage fraud has

been defined as “the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan” (Federal Bureau of Investigation, 2004). It also includes providing misleading information when making a mortgage application (Vacco, 2009, p. 248). There are two types of mortgage fraud – fraud for property and fraud for profit (O’Donnell and Planer, 2008, p. 54) which are associated with property flipping, straw buyers, equity skimming, builder bailout, buy and bail, chunking, double selling, phantom sales, property flip fraud, reverse mortgage fraud and short sale fraud (Federal Financial Institutions Examinations Council, 2009, p. 8). Prior to the onset of the financial crisis, the FBI estimated that extent of mortgage fraud in 2006 was \$4.2bn (Federal Bureau of Investigation, 2007). It was declared to be an “escalating problem” in 2007 (Federal Bureau of Investigation, 2008) and in 2008, the reported losses from mortgage fraud increased by 83 per cent to \$1.4bn (Federal Bureau of Investigation, 2009a). In 2009, the FBI citing ‘Core Logic’, estimated that the total amount of losses related to mortgage fraud had increased to \$14bn (ibid). ‘Core Logic’ estimated that the extent of mortgage fraud in 2011 was \$12bn (2011, p. 1). In its 2011 mortgage fraud report ‘Core Logic’, projected that that the level of mortgage fraud had increased to \$13bn (ibid).

Further evidence of the association between the financial crisis and mortgage fraud is illustrated by the significant increase number of related SARs submitted to the Financial Crimes Enforcement Network (FinCEN). For example, between 1996 and 2006 FinCEN received 82,851 mortgage fraud related SARs (FinCEN, 2006, p. 4). During this period the number of suspected instances of mortgage fraud reported to FinCEN increased by 1,400 per cent (Mahallati, 2010, p. 712). In 2008 FinCEN reported that between 2006 and 2007 it received 37,313 mortgage fraud SARs (2008, p. 4). This figure represented 45 per cent of the total mortgage fraud related reports it received between 1996 and 2006. In 2010 the number of mortgage fraud related SARs received by FinCEN numbered 70,472 (FinCEN, 2011, p. 2). The number of SARs significantly increased to 92,028 in 2011 (FinCEN, 2012, p. 3). It was reported that in 2011, FinCEN received 93,508 mortgage-fraud relates SARs, an increase of 33 percent (Lexis Nexis, 2012, p. 3). However, FinCEN reported in 2012 that there was a 25 percent drop in the number of mortgage fraud related SARs (FinCEN, 2013). This position was succinctly summarised by Smith who noted “the past decade has witnessed an explosion of mortgage fraud, with reports ... rising by a magnitude of over eighteen times from 2000 to 2008” (2010, p. 473). However, it has been argued that the figures from FinCEN only

represent a small percentage of the true extent of mortgage fraud. For example, Black took the view that “the total SARs figure is only a faint indication of the true incidence of mortgage fraud” (2011, p. 597). It is also interesting to note that “mortgage fraud, far from abating, has only expanded since the foreclosure crisis began” (Fisher, 2009, p. 121). The association between mortgage fraud and the financial crisis is also illustrated by an increase in the investigative and enforcement activities of the FBI. For example, since the start of the financial crisis we have witnessed a 400 per cent increase in the number of mortgage fraud investigations undertaken by the FBI (Heroy, 2008, p. 322). In response to the increasing levels of mortgage fraud and related SARs submitted to FinCEN, the FBI established 84 mortgage fraud task forces; there are approximately 2,000 on-going investigations, over 1,000 indictments and over 1,100 convictions have been obtained. Moye summarised the overall impact of mortgage fraud from a law enforcement perspective:

From 2007 through 2010, the number of federal mortgage fraud cases increased from 1,200 to over 3,000. Almost 70 per cent of those fraud cases involved losses exceeding \$1m. In June 2010, the Department of Justice announced the results of Operation Stolen Dreams, the largest mortgage fraud sweep in history. The sweep lasted three and a half 422 months, involved 1,517 defendants, 863 indictments, 525 arrests, and involved over \$3.05bn in losses (2011, p. 421).

Nonetheless, the reliability of the figures provided by the FBI has been questioned by the Department of Justice’s Inspector General’s Office who concluded that the total number of mortgage fraud related prosecutions could be less than expected (Richman, 2014, 265). Black was also very critical of the response from the FBI and stated that “the elite frauds that drove the current crisis have not even been subjected to a serious investigation” (2012, p. 987).

## **5. An alteration of policy**

The declaration of the ‘War on Terrorism’, the instigation of the ‘Financial War on Terrorism’ and the prioritisation of Homeland Security had an adverse impact on the ability of the FBI to tackle mortgage fraud. The impact of the ‘War on Terrorism’ on the Department of Justice was recognised by the then Attorney General who noted that the “war on terrorism became *the* [author’s emphasis] overriding focus of the Department of Justice

and my mission as Attorney General became clear: to transform a peacetime Justice Department ill-prepared for the challenges of 9/11, into wartime Justice Department” (Ashcroft, 2009, p. 813). As a result of this alteration in priority, the FBI and a large number of US Attorneys’ officers became responsible for “fighting the domestic portion of the War on Terror” (Richman and Stuntz, 2005, p. 583). This decision was questioned by commentators who argued that the Department of Justice “led by organized-crime prosecutors, [became] ... an extension of the Defence Department in the ‘War on Terrorism’, as the USA Patriot Act [2001] provides a new role for law enforcement in fighting terrorism. The boundaries between war and law enforcement are now very blurry” (Baker, 2004, p. 310). It is very interesting to note that despite the necessity to promote Homeland Security and the related extension of the remit of the FBI and Department of Justice, the threat posed by mortgage fraud *was* recognised by many commentators before the start of the financial crisis. For example, the FBI warned that “if fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions at risk and have adverse effects on the stock market” (Federal Bureau of Investigation, 2009b). Furthermore, an assistant director of the FBI described the threat posed by mortgage fraud in 2004 as having the “the potential to be an *epidemic* [author’s emphasis]” and that “we think we can prevent a problem that could have as much impact as the Savings and Loans crisis” (Federal Bureau of Investigation, 2004). These statements were also used by other media outlets including Reuters who warned that the FBI “after years spent focusing on national security, is struggling to find agents and resources to investigate wrongdoing tied to the country’s economic crisis” (Michaud, 2008). Furthermore, the Los Angeles Times reported that “a massive shift of FBI agents to anti-terrorism and counter intelligence duties has *undermined* [author’s emphasis] the work of fraud investigators, who are taking on fewer scam artists and corporate miscreants and taking longer to complete cases” (Eckard, 2004). Lichtblau et al. stated that:

Since 2004, FBI officials have warned that mortgage fraud posed a looming threat, and the bureau has repeatedly asked the Bush administration for more money to replenish the ranks of agents handling non-terrorism investigations, according to records and interviews. But each year, the requests have been *denied* [author’s emphasis], with no new agents approved for financial crimes, as policy makers focused on counterterrorism (2008).

This was a view supported by Black, one of the most vociferous critics of the US approach towards mortgage fraud, who famously declared that “an expanding epidemic of mortgage fraud existed. The Federal Bureau of Investigation ... warned Congress ... in September 2004 that an ‘epidemic’ of mortgage fraud was developing and predicted that it would produce an economic ‘crisis’ if it were not contained”. Black added that despite this forthright statement from the FBI, “no one in the industry, including regulators, ranks of investors or creditors, or law enforcement personnel took effective action against the epidemic” (2011, p. 597).

A clear link between the instigation of the ‘War on Terrorism’ and the benign neglect by the Bush administration towards mortgage fraud was the diversion of significant resources away from the FBI’s white collar crime team towards tackling terrorism and maintaining Homeland Security. The reduction in white collar crime FBI agents was recognized by the Financial Crisis Enquiry Commission Report, who stated that the number of assigned agents towards white collar crime dropped from 2,342 to less than 2,000 (Financial Crisis Enquiry Commission, 2011, p. 5). The Commission added that in 2007 only 150 agents were available to investigate over 54,000 mortgage fraud related SARS filed with the FinCEN. The direct association between the redistribution of its special agents and mortgage fraud was highlighted by Creseney et al. who described this process as becoming an “obstacle” that adversely affected the ability of the FBI to investigate allegations of mortgage fraud (2009, p. 238-239). Indeed, Creseney *et al.* concluded that by 2007 “the number of FBI agent’s nationwide pursuing mortgage fraud had shrunk to about 100, in sharp contrast to the roughly 1,000 agents that were deployed on banking fraud during the Savings and Loans crisis of the 1980s and 1990s” (ibid). Similarly, Podgor condemned the decision by President George Bush to promote Homeland Security and stated that “the reduction in [FBI] agents likely resulted in the reduced number of white-collar prosecutions” (2010, p. 205). The diversion of resources resulted in the New York Times concluding that “the FBI is struggling to find enough agents and resources to investigate criminal wrongdoing tied to the country’s economic crisis” (Lichtblau et al, 2008). Despite numerous pleas by law enforcement agencies and the Mortgage Bankers Association for more federal funding to tackle mortgage fraud, it was *consistently* and *incorrectly* rejected by President George Bush. This was acknowledged by Robert Mueller, the Director of the FBI, who informed the Financial Crisis Enquiry Commission Report that he had asked for more resources to tackle mortgage fraud but “didn’t get what we had requested” (Financial Crisis Commission, 2011, p. 163).



Additionally, it has been argued that the Bush Administration disregarded the threat posed by mortgage fraud and that they provided hardly any financial support for the FBI (ibid, p. 164). However, the former Attorney General Alberto Gonzales argued that “I don’t think anyone can credibly argue that [mortgage fraud] is more important than the war on terror. Mortgage fraud doesn’t involve taking loss of life” (Financial Crisis Commission, 2011, p. 163). This statement is another example of the negligent attitude towards mortgage fraud that was afforded by the Bush administration. It is abundantly clear that despite warnings and requests for additional funding from the FBI, President George Bush adopted an apathetic stance towards mortgage fraud.

However, the strategy towards mortgage fraud gained significant momentum when President Barak Obama came into office in January 2009. One of the first legislative measures introduced to tackle white collar crime associated with the financial crisis was the Fraud Enforcement and Recovery Act 2009 (Pub.L. 111–21). The origins of this legislation are to be found in an initial, but abortive legislative attempt to combat mortgage fraud that was tabled in April 2007 by then Senator Barack Obama and Senator Dick Durbin. The Bill was entitled ‘Stopping Mortgage Transactions which Operate to Promote Fraud, Risk, Abuse, and Underdevelopment Act’. The Bill sought amend fraud legislation by imposing tougher criminal sanctions up people who were convicted of mortgage fraud. In particular sought to increase the custodial sentence to 35 years and also increase the levels of financial penalties to \$5m. The proposals also aimed to enlarge the breadth of reports and evidence of mortgage fraud that were submitted to FinCEN. However, the Bill was not signed into law by the President George Bush because it ran out of Congressional time. Nonetheless, following the 2008 Presidential election, the Fraud Enforcement and Recovery Bill was reintroduced in February 2009 and it was signed into law by President Barak Obama on May 20 2009 (The White House, 2009). Reidy suggested that the 2009 Act was a reaction to what he described as “economic calamity ... ostensibly combating the type of chronic misconduct which may have helped foster economic instability rather than merely combating the acute symptoms of such instability” (2010, p. 295). The Act was also viewed as a “broad-based anti-fraud measure, designed to create more tools to prosecute fraud at all levels” and to “help protect Americans from future frauds that exploit the economic assistance programs intended to restore and rebuild [the] economy” (Lover, 2010, p. 1129). The Act contained five important provisions. Firstly, it provided a significant increase in the funding for the Department of Justice and FBI to combat fraud. Baer noted that “over a two-year period, [the Act]

authorized the injection of an additional \$500m [to agencies] with jurisdiction over crimes ostensibly related to the financial crisis” (2012, p. 577). The additional funding resulted in an increase in the number of appointed fraud related prosecutors and investigators (Valukas, 2010, p. 1). The Department of Justice welcomed the additional funding and stated that the Act had granted them essential “further resources to increase the scope of our collective enforcement response” (Department of Justice, 2011). Secondly, the Fraud Enforcement and Recovery Act 2009 made some important amendments to fraud and money laundering legislation. Thirdly, the Act increased the penalties for those convicted of mortgage fraud. Fourthly, the Act extended the definition of financial institutions to include private mortgage lending businesses and mortgage brokers. Fifthly, the Fraud Enforcement and Recovery Act 2009 increased the supervision of Troubled Asset Relief Programme. Additionally, the Act contained measures to tackle healthcare fraud, it established the Financial Crisis Inquiry Commission, extended the protection afforded to fraud related whistleblowers and amended the False Claim Act 1986. The False Claims Act now permits the government and private parties the ability to recuperate money that has been lost to fraud. This measure has become one of the most significant anti-fraud devices utilised by the government in civil fraud cases (Love, 2012, p. 1129).

The decision to provide additional funding for the Department of Justice and the subsequent increase in enforcement activities, as outlined above, represented a significant alteration in policy towards mortgage fraud from the previous administration (Smith, 2010, p. 474-475). Indeed, the Fraud Enforcement and Recovery Act 2009 was welcomed by the Department of Justice who stated that it “would provide federal investigators and prosecutors with significant new tools and resources, both civil and criminal, with which to combat mortgage fraud, securities and commodities fraud and related offenses” (Department of Justice, 2009). Mcann concluded that “the overall effect of the statutory enhancements and resources that FERA provides to federal law enforcement will be to more effectively police the home mortgage market ... as a result ... [it] will be more secure” (2010, p. 352). Despite the obvious merits of the Act, it has been criticised. For example, it has been asserted that the provisions amounts to a rash and hasty response to the financial crisis (ibid, 377). Indeed, Lowell and Arnold argued that politicians have bowed to pressure from consumer groups and turned towards criminal law provisions (2003, p. 219). The scope of the Act has questioned by Valukas who stated that merely providing additional funding and increasing the number of fraud related prosecutions don’t go far enough (Valukas, 2010, p. 13). Moyer stated that the

Act “does not go far enough to eradicate fraudulent claims submitted to the government and its programs. Clearly, the law attempts to tie up loose ends from the financial crisis, but it could go further to send a message to those violating the law” (2011, p. 429). However, Ceresney et al warned that “it is unlikely that they will be successful in systematically prosecuting the frauds that may have triggered the credit crisis” (2009, p. 243). Nonetheless, the Fraud Enforcement and Recovery Act 2009 represented a bold attempt by President Barak Obama to redress some of the imbalances created by President George Bush, who wrongly prioritised the ‘War on Terrorism’ at the expense of mortgage fraud. The Act has allowed the Department of Justice and FBI, to pursue white collar criminals who have contributed toward the financial crisis, albeit low level traders. This is demonstrated by the increase in mortgage fraud convictions and ongoing investigations by the FBI. The link between the terrorist attacks in September 2001, the financial crisis and white collar crime, has been directly influenced by the decision by President George Bush to prioritise terrorism and national security over mortgage fraud. The diversion of resources away from mortgage fraud, despite several warnings and pleas from the FBI, left them unprepared and ill-equipped to deal with the incoming tsunami of mortgage fraud cases.

## **6. Conclusion**

The aim of this article was to provide an alternative commentary on the association of the financial crisis with white collar crime, and how this relationship was fostered by the declaration of the ‘War on Terrorism’ and the ‘Financial War on Terrorism’ in September 2001. The instigation of the both of these measures was to have a profound and adverse impact on the ability of the FBI to combat mortgage fraud. The decision to promote Homeland Security at the expense of mortgage fraud would result in the catastrophic redistribution of FBI white collar crime agents to tackle terrorism, under the guise of the Homeland Security Act 2002. The creation of the Department of Homeland Security became one of the most significant reorganisations of the US governments in several decades. This saw the merger of numerous government, state and local agencies under one institution, which has been consistently provided with a huge annual budget, to promote homeland security and reduce the threat posed to the US by terrorism. Since the instigation of the ‘War on Terrorism’ in September 2001, the Counter Terrorism Section of the Department of Justice has secured 494 terrorist related convictions (Federation of American Scientists, 2012). However, these statistics, like those cited by the FBI, have been questioned and it has

been suggested that they are inaccurate (Department of Justice, 2013). A direct result of the 'Financial War on Terrorism' was the adoption of an ill-advised CTF policy that was based on the existing AML model. The implementation of an AML model, that was originally used to target the laundering of the proceeds of criminal offences, was inappropriate to tackle terrorism. Terrorists will not use the proceeds of crime to disguise the true origins of the criminal offence; they will use the finances to commit acts of terrorism. The CTF model was initially based on extending the reporting obligations to the financing of terrorism that were contained in the BSA 1970. This was soon followed by the extension of the powers of the residing President to impose economic sanctions on enemies of the US at times of war. Yet, again this part of the US CTF policy must be questioned as there has not only been a significant reduction in the number of states sponsoring terrorism according to the US Department of State, but it is difficult to impose economic sanctions on terrorist groups such as Islamic State, Boko Haram and Al Shabaab. The untimely merger of the AML and CTF policies was mandated by the introduction of the Money Laundering and Financial Crimes Act 1998. This legislation was soon followed and further strengthened by the introduction of the USA Patriot Act 2001 and the signing of Presidential Executive Order 13,224. These measures domestically implemented the 'Financial War on Terrorism' in the US and jettisoned mortgage fraud from the peak of the FBI's white collar crime strategies. The actions of President George Bush following the terrorist attacks in September 2001 were to have a profound impact on the ability of US law enforcement agencies to tackle mortgage fraud; the financial crime is associated with the financial crisis. Mortgage fraud, is directly linked to its primary cause, the collapse of the subprime mortgage market. The subprime mortgage sectors grew at a spectacular rate before the onset of the financial crisis in 2007. For example, by 2006 the number of subprime mortgages peaked and accounted for over 25 per cent all US mortgages. Financial institutions, who were eager to profit from subprime mortgages contributed to their rapid growth. However, when the subprime market collapsed in 2007 a number of financial institutions suffered significant losses with many applying for bankruptcy protection. Additionally, homeowners also suffered as a result of the failure and there was a dramatic increase in the number of repossessions, which resulted in the discovery of widespread instances of mortgage fraud. This point has been clearly illustrated by the significant increase in levels of mortgage fraud since the onset of the financial crisis, a substantial surge in the number of reported instances of mortgage fraud to FinCEN and the related upturn in mortgage fraud related prosecutions by the FBI. However, the article has presented evidence from the FBI, who in 2004, warned of the threat posed by mortgage

fraud and asked President George Bush for additional funding to counter act this perceived threat. These warnings and pleas were consistently ignored by the Bush administration and left the FBI and other related law enforcement agencies with little resources to prevent in incoming flux of mortgage fraud related cases. The position was redressed in 2009 with the introduction of the Fraud Enforcement and Recovery Act by President Barak Obama, which redressed the imbalance of the strategies adopted by President George Bush.

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