Illegal Cash-Back Deals Worsened The Housing Bubble, Drove Up Foreclosures: Report

It’s a tactic that’s been in use for years: Sell a house to someone at an inflated price, but offer the buyer an incentive to take it -- like a few thousand dollars in cash back.

This maneuver puts extra money in the homeowner’s pocket. But it can make her more likely to experience foreclosure down the line, according to a new report. And because it involves buyers and sellers transferring money without informing the lender -- and exposing the lender to risk they don’t know about -- it’s also a form of mortgage fraud, and therefore illegal.

In a study recently published in American Economic Journal: Applied Economics, Itzhak Ben-David, an assistant professor of finance at Ohio State University’s Fisher College of Business, offers a
thorough look at how inflated housing prices and cash-back incentives took a toll on homeowners in Illinois’s Cook County, which includes Chicago.

Ben-David examined more than 700,000 home sales in Cook County, spanning January 1995 to April 2008. He zeroed in on suggestive language in the real estate listings -- like “Let's talk about cash back at closing!!!”; “$10,000 back with full price”; and “Free car with full price” -- that indicated price inflation was taking place.

What he found was that these deals represented between 2.9 and 4.4 percent of all the transactions in that 13-year period -- although in the years between 2005 and 2008, they might have accounted for as many as 6.1 percent.

Residents of Arizona, Florida, and California, where cash-back deals were common during the height of the housing bubble, might not be surprised to learn how prevalent this practice was in Cook County. In 2007, a broker at a Phoenix realty company predicted to The Arizona Republic that cash-back deals “will hurt everyone in the industry and the housing market.”

The same year, San Diego Magazine reported on the increasing incidence of cash-back deals in California -- and in the country at large. And a few months later, The Palm Beach Post reported that so-called “cash back at closing” deals were “going on in every neighborhood in Palm Beach County,” in the words of one local detective.

In Cook County, the deals didn’t work out so well for homeowners. Ben-David found that among highly leveraged borrowers -- those who’d borrowed more than 80 percent of the home price -- foreclosure rates were between 0.6 and 3.9 percent higher during the first year for borrowers who’d agreed to an inflated price.

Such transactions may have had a ripple effect into other home sales.

A report from the Government Accountability Office, released Wednesday, noted that one of the most common methods home appraisers use to determine the value of a house -- the so-called “sales comparison approach,” in which a value is set based on the prices that other, similar properties have recently sold for -- is sometimes susceptible to a feedback effect.

The GAO report states:

One criticism of the sales comparison approach is that it may perpetuate price trends in overheated (or depressed) markets. For example, the use of comparable sales with inflated sales prices (driven up by factors that increase consumer demand, such as expanded credit availability) can lead to progressively higher market valuations for other properties, which in turn become comparables for future sales transactions.

This echoes a point Ben-David made about the collateral effects of cash-back deals in a press release accompanying his study.

"These inflated price transactions increased the general level of prices in the neighborhood," Ben-David said, "so that, after the boom, when houses returned to their original values, the crash was more severe.”

FOLLOW HUFFPOST BUSINESS