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MORTGAGE FRAUD AND ITS IMPACT ON MORTGAGE LENDERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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MORTGAGE FRAUD AND ITS IMPACT ON MORTGAGE LENDERS

Thursday, October 7, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Robert W. Ney [chairman of the subcommittee] presiding.

Present: Representatives Ney, Miller of California, Hart, Tiberi, Renzi, Waters, Velazquez, Carson, Lee, Watt, Scott, and Davis.

Chairman NEY. Today, the Housing Subcommittee meets to discuss mortgage fraud and its effect on mortgage lenders.

The subcommittee, along with Chairman Bachus' Financial Institutions Subcommittee, conducted a number of hearings concerning abuse of lending practices, subprime lending and how to ensure credit availability for those who need it and want it.

During these previous hearings, topics revolved around addressing fraudulent schemes and how it affects the individual consumer. However, consumers are not the only ones affected by abusive lending practices. Financial institutions and other lenders, also victims of mortgage fraud, lose millions of dollars each year through this type of problem and corruption.

Some studies have shown that between 10 and 15 percent of all home loan applications include some home loan fraud or misrepresentation. Lenders can choose to absorb the loss and reduce earnings that harm stockholders or charge higher consumer fees to recoup those losses.

Government-insured loans that fall victim to fraud end up being paid at the end of the day by the taxpayers. The examples of this fraudulent behavior include elaborate schemes, straw buyers, fake credit histories, inflated appraisals, fabricated pay stubs and falsified tax records.

Of today's witnesses—we are happy to have all the witnesses today—but one of today's witnesses from the Federal Bureau of Investigation has stated that mortgage fraud has become, potentially, a national epidemic that could expose lenders to hundreds of millions of dollars in losses. And, of course, those losses go down the line and affect everybody.

As a result, the Bureau has targeted a variety of fraud schemes through its Operation Continued Action, the largest nationwide op-

eration in FBI history, directed toward organized groups and individuals who are engaged in mortgage fraud.

From its inception in August of 2004 through this month, Operation Continued Action investigators have identified more than 245 subjects and 158 investigations in 37 States. More than 151 indictments have been filed to date. These charges have thus far led to more than 144 arrests, convictions and sentences and millions of dollars in forfeiture and restitution.

The United States mortgage market is the deepest and most affordable in the world due to the evolution of unique funding structures for mortgages, and Americans pay less for mortgages than almost any other country. As a result, this country has the world's highest home ownership rate.

Today's hearing is another important step, as we attempt to find common ground with comprehensive solutions to the problem of abuse of lending. I would also note, without objection, that the record will be open for 30 days for members to ask additional questions of the panel.

And with that, I would yield to Mr. Scott. Thank you for joining us.

Mr. SCOTT. Thank you very much, Mr. Chairman. I want to thank you, Mr. Chairman, for holding this hearing on the subject of mortgage fraud and certainly want to extend a welcome to all the distinguished members of the panel.

This hearing is important to me because as the Mortgage Asset Research Institute will discuss today, my State of Georgia has surpassed California and Florida as the State with the highest mortgage fraud scores. In his written testimony, the HUD Inspector General provided an example of mortgage fraud in DeKalb County in Georgia. This particular incident occurred just outside of my district, and represents just one of many anecdotal stories of mortgage fraud and predatory lending in the metro-Atlanta area.

Most mortgage scams are caused by a small number of local fraudulent loan operators. However, the mortgage scams run by these small operators cause enormous pain for their victims. While mortgage fraud may be a huge problem, it pales in comparison to the devastation experienced by individual homeowners who are victims of predatory lending. I am concerned that there is no way to know the exact level of mortgage fraud.

Several witnesses in their testimony identified the lack of information as being a problem for preventing mortgage fraud. I am very pleased that the FBI has increased its investigations into mortgage fraud, and I believe that Congress should give the FBI the necessary resources to expand their operations.

With the FBI's primary focus on homeland security, Congress must also strengthen existing laws to help State and local investigators share the workload of investigating mortgage fraud.

In addition, Congress must continue to promote financial literacy efforts, which is a strong priority of this committee.

I look forward to hearing from today's witnesses on the ways to investigate, to prosecute and to stop mortgage fraud. And I want to certainly recognize William Matthews of the Mortgage Asset Research Institute, who is a witness today, and his company is a sub-

sidiary of ChoicePoint, which is based in my district in Atlanta, Georgia.

Thank you very much, Mr. Chairman. I yield back my time and look forward to a very informative hearing this morning from our distinguished panels.

Chairman NEY. I want to thank the gentleman.

Also, without objection, we have written testimony for the record—hearing no objection—from the National Association of Home Builders, Kevin Coop, and Consumer Mortgage Coalition.

We have been joined by the gentleman from Ohio, and—he has left, the gentleman from Ohio. He will be back.

With that, we begin the panel.

Kenneth Donohue is the Inspector General of the United States Department of Housing and Urban Development. He has a distinguished 21-year career, serving as a Special Agent with U.S. Secret Service, and he later served as Chief of the Investigation Section of the Resolution Trust Corporation. He is a Certified Fraud Examiner and a Certified Protection Professional.

Chris Swecker is the Assistant Director of the Criminal Division at the Federal Bureau of Investigation, having been named to this position by Director Mueller in July. Mr. Swecker joined the FBI as a Special Agent in 1982. He served in the FBI's Legal Counsel Division in the Organized Crime and Narcotics Office. He was designated Special Agent in Charge of the Charlotte Division in 1999.

John Weicher, Assistant Secretary for Housing, Fair Housing Division, at the Housing and Urban Development, a position he has now held since June of 2001. He has been here several times on the Hill.

We welcome you back.

Prior to the appointment at HUD, Mr. Weicher was Director of Urban Policy Studies at the Hudson Institute. He also served as a member of the Millennial Housing Commission.

We want to welcome all the witnesses today.

I would note our most famous previous FBI agent was Chairman Mike Oxley of Ohio, so I had to note that.

With that, we will begin with you, Mr. Donohue.

STATEMENT OF HON. KENNETH M. DONOHUE SR., INSPECTOR GENERAL, UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. DONOHUE. Chairman Ney, and other members of the subcommittee, it is my pleasure to testify before you today on the HUD Inspector General's perspective on mortgage fraud and its impact on financial institutions. Of all the homes purchased in the United States each year, 8 percent are financed with FHA mortgage insurance. Each year, FHA accounts for 30 percent of all insured mortgages. FHA has fallen off nearly 20 percent from the same period a year ago. FHA-insured mortgages may be more prone to mortgage fraud because FHA insures mostly first-time home buyers with limited credit history and little money down.

A closer look at the make-up of the FHA portfolio would indicate that FHA's insurance risk is increasing. A comparison of active insured FHA cases to FHA claims cases over the past 2 years shows an increasing claim rate.

As you can see from our chart, our investigative workload has increased in more than 450 open criminal, single-family investigations, and our arrests in the single-family mortgage area have increased 800 percent in a 4-year period. We believe there is a direct relationship between our increased workload and the FHA's increasing claims rate.

The annual audit of the Federal Housing Administration financial statement has found the FHA in basically sound fiscal condition. FHA's claim rate, however, continues to rise each year, and with fewer FHA mortgage applicants, there is less premium income to cover the claims.

A future economic downturn and future interest rate increases would provide opportunities for those who would prey upon homeowners who cannot make their mortgage payments. We repeatedly have found unlawful and deceptive practices and outright fraud in mortgage lending that often exploit first-time and uninformed FHA borrowers.

Of particular concern is illegal profiteering on the purchase and quick resale of homes called "property flipping." the illegality arises because one or more parties to the transaction conspire to inflate the value of the home and pocket the excessive profits at loan closing.

Another concern is "equity skimming." A common form of equity skimming involves an investor who exploits a homeowner facing foreclosure and other financial stress.

Mortgage fraud can go undetected, and not all fraud results in loss to the government. This makes it difficult to quantify the exact amount or even the estimated amount of mortgage fraud.

Every month one in every nine FHA mortgages is reported as delinquent. That means that 600,000 FHA borrowers are a month behind in paying their mortgages. Some portion of these delinquencies may be due to mortgage fraud and new mortgages where the underwriter intentionally misrepresented the borrower's ability to pay the mortgage.

The following are two examples that combine OIG-FBI investigations of "property flipping" frauds and the results of a recent audit of mortgage fraud:

Three conspirators preyed on unwitting FHA borrowers in Chicago's south and west sides, saddling the new homeowners with overvalued properties and unmanageable mortgage debt. The fraud scheme was a typical flip. The investor would contract to purchase a property, recruit home buyers, and then partner with a crooked appraiser and attorney to complete the resale and closing at an inflated price.

As you can see from the pictures on the easel, this example of one of the properties shows how significantly it declined in appearance and how it could potentially impact the surrounding neighborhood when one of these fraudulent transactions occurred.

Earlier this year, a 158-count indictment was handed down in the Northern District of Georgia. From mid-1999 through March of 2004, it was alleged the settlement attorney and coconspirators perpetrated a property flipping scam. The defendants purchased residential properties primarily in the Stone Mountain, Georgia, vi-

cinity and resold them at artificially inflated prices, using the proceeds of the resale to pay for the initial purchase.

In a recent audit of an FHA-approved lender, we found the lenders were fabricating or altering borrower credit and employment documents to make the loans approvable. In this audit we found pervasive documents falsifying in 48 of 65, 75 percent, of the FHA loans originated by a HUD-approved correspondent lender in the greater Phoenix metropolitan area.

Mr. Chairman, I appreciate the subcommittee's concern over the increased problem of mortgage fraud. The result of these types of financial crimes undermines the confidence in this Nation's housing industry and frustrates honest American dreams of home ownership. In addition, the victims include the honest mortgage company employees that lose their jobs because they are victimized by unsavory business practices of other staff, the home buyers whose credit was destroyed when they had to default on a loan that they really could never afford in the first place, or the new FHA home buyer that is paying a higher than necessary mortgage premium to cover growing losses to the insurance fund.

Thank you, sir.

Chairman NEY. Thank you for your statement.

[The prepared statement of Hon. Kenneth M. Donohue Sr. can be found on page 55 in the appendix.]

Chairman NEY. Mr. Swecker.

STATEMENT OF CHRIS SWECKER, ASSISTANT DIRECTOR, CRIMINAL INVESTIGATIVE DIVISION, FEDERAL BUREAU OF INVESTIGATION

Mr. SWECKER. Good morning, Mr. Chairman and members of the subcommittee. I want to thank you for the opportunity to testify before you today about the FBI's efforts——

Chairman NEY. If you would just move the mike a little closer.

Mr. SWECKER.—in combating mortgage fraud.

Although there is no specific statute that defines mortgage fraud, each mortgage fraud scheme contains some type of material misstatement, misrepresentation or omission relied upon by an underwriter or lender to fund, purchase or insure a loan. The Mortgage Bankers Association projects 2.5 trillion in mortgage loans will be made this year. The FBI compiles data on mortgage fraud through Suspicious Activity Reports filed by financial institutions and HUD Office of the Inspector General reports. The FBI also receives complaints from the industry at large.

A significant portion of the mortgage industry is void of any mandatory fraud reporting. In addition, mortgage fraud in the secondary market is often underreported. Therefore, the true level of mortgage fraud is largely unknown. The mortgage industry itself does not provide estimates on total industry fraud. The industry provides incomplete or inconsistent fraud data. Based on various industry reports and FBI analysis, mortgage fraud is pervasive and growing.

The FBI investigates mortgage fraud in two distinct areas: Fraud for Housing and Fraud for Profit. Fraud for Profit is sometimes referred to as "Industry Insider Fraud" and the motive is to remove equity, falsely inflate the value of the property or issue loans based

on fictitious properties. Based on existing investigations and mortgage fraud reporting, 80 percent of all reported fraud losses involve collaboration or collusion by industry insiders. These schemes involve industry insiders to override the lender controls.

Fraud for Housing represents illegal actions perpetrated solely by the borrower. The simply motive behind this fraud is to acquire and maintain ownership of a house under false pretenses. This type of fraud is typified by a borrower who makes misrepresentations regarding income or employment history to qualify for the loan.

In the past 18 months, the FBI has been evaluating the effectiveness of its national mortgage fraud program. In June, 2004, I authorized the consolidation of the mortgage fraud program into the Financial Crimes Section of the FBI's Criminal Division. Previously, mortgage fraud that impacted government programs, for example, HUD, was managed by another section. Mortgage fraud affecting financial institutions was managed by the Financial Crimes Section. This consolidation provides the FBI a more effective and efficient management over mortgage fraud investigations.

Second, I encouraged an overall strategy to address mortgage fraud on a proactive basis, utilizing partnerships of Federal agencies, State and local law enforcement, regulatory bodies and private industry.

Third, I assured adequate personnel resources were dedicated to emerging mortgage fraud problems in regions of the country encountering the greatest levels of fraud.

And finally, the FBI adopted an overall strategy to focus on insiders harming the industry in order to disrupt and dismantle entire criminal enterprises.

The FBI defines industry insiders as appraisers, accountants, attorneys, real estate brokers, mortgage underwriters and processors, settlement/title insurance employees, mortgage brokers, loan originators and other mortgage professionals engaged in the mortgage industry. Through a mandatory reporting mechanism, industry insiders would be the front line in preventing mortgage fraud. Zero tolerance within the industry, combined with a mandatory system of reporting fraudulent activities to the FBI and HUD, would be a major step in addressing mortgage fraud.

The potential impact of mortgage fraud on financial institutions in the stock market is clear. 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. Investors may lose faith and require higher returns from mortgage-backed securities, which will result in higher interest rates and fees paid by borrowers, limiting the amount of investment funds available for mortgage loans.

Often mortgage loans sold in secondary markets are used by financial institutions as collateral for other investments. Repurchase agreements have been utilized by investors for protection against mortgage fraud. When loans sold in the secondary market default and have fraudulent or material misrepresentation, loans are repurchased by the lending financial institution based on a repurchase agreement. As a result, these loans become a nonperforming

asset, and in extreme fraud cases, the mortgage-backed security is worthless. Mortgage fraud losses adversely affect loan loss reserves, profits, liquidity levels and capitalization ratios, ultimately affecting the soundness of the financial institution itself.

Over the past 5 years, the FBI has implemented new and innovative methods to detect and combat mortgage fraud. One of these proactive approaches was the development of a property flipping analytical computer application, first developed in the Washington field office to effectively identify property flipping in the Baltimore and Washington areas. The original concept has evolved into a national FBI initiative which employs statistical correlations and other advanced computer technology to search for companies and persons with patterns of property flipping.

As potential targets are analyzed and flagged, the information is provided to the respective FBI office for further investigation. Property flipping is best described as purchasing properties and artificially inflating their value through false appraisals. The artificially valued properties are then repurchased several times for a higher price by associates of the "flipper." after three or four sham sales, the properties are foreclosed on by victim lenders. Often properties are ultimately repurchased for 50 to 100 percent of their original value.

Other methods we have used include undercover operations and wiretaps. These investigative measures often result in collecting valuable evidence and provide an opportunity to apprehend criminals in the commission of their crimes and reduce losses to financial institutions. These proactive methods do not preclude historical investigations; however, they provide the FBI with additional tools to conduct large-scale investigations through operational efficiencies.

As far as trends, there are many mortgage fraud schemes. The FBI is focusing its efforts on those perpetrated mostly by industry insiders. The FBI is engaged with the mortgage industry in identifying fraud trends and educating the public. Some of the current rising mortgage fraud trends include: equity skimming, property flipping, and mortgage identity-related theft.

Equity skimming is a tried and true method of committing mortgage fraud and criminals continue to devise new schemes. Today's common equity skimming schemes involve the use of corporate shell companies, corporate identity theft and the use or threat of bankruptcy or foreclosure to dupe homeowners and investors.

Property flipping is nothing new. However, once again, law enforcement is faced with an educated criminal element that is using identity theft, straw borrowers and shell companies to conceal their methods and override lender controls. It should be noted that identity theft in many forms is a growing problem and is manifested in many ways, including mortgage documents. The mortgage industry has indicated that personal, corporate and professional identity theft in the mortgage industry is on the rise. Computer technology advances and the use of online resources have also assisted the criminal in committing mortgage fraud.

The FBI and its law enforcement industry partners are working together to identify these trends and develop techniques to thwart illegal activities in this area. The FBI focuses on fostering relation-

ships and partnerships with the mortgage industry to promote mortgage fraud awareness.

Over the past 2 years the FBI has spoken and participated in various mortgage industry conferences and seminars, including those sponsored by the Mortgage Bankers Association. This year, we will be speaking at and participating in the MBA's 91st Annual Convention and Expo. The MBA estimates that 6,000 industry leaders will attend that conference.

To raise awareness of this issue and provide easy accessibility to investigative personnel, we have provided contact information for all FBI mortgage fraud supervisors to relevant groups, including the MBA, Mortgage Asset Research Institute, Fannie Mae, Freddie Mac and others.

Additionally, we are collaborating with industry to develop a more efficient mortgage fraud reporting mechanism for those not mandated to report such activity. This Suspicious Mortgage Activity Report or concept is under consideration by the Mortgage Bankers Association.

The FBI supports providing a safe harbor for lending institutions, appraisers, brokers and other mortgage professionals similar to the provisions afforded to financial institutions providing "safe harbor" information. The "safe harbor" provision would provide necessary protections to the mortgage industry under a mandatory reporting mechanism. This will also better enable the FBI to provide reliable mortgage information based upon a representative population in the mortgage industry.

A recent analysis of mortgage industry fraud surveys identified 26 different States as having significant mortgage fraud problems. Although every survey identified Florida and Georgia as having significant mortgage fraud-related investigations, the survey also identified nine other States in the South and Southwest, seven States in the West and five States in the Midwest as having mortgage fraud problems. Once again, these studies illustrate the need for increased coordination among industry and law enforcement on mortgage fraud.

In conclusion, the FBI is committed to increasing liaison and education efforts and partnering with Federal, State and local enforcement and private industry to combat mortgage fraud. We support new approaches to address mortgage fraud and its effects on the U.S. Financial system to include a mechanism to require the mortgage industry to report, fraudulent activity and the creation of "safe harbor" provisions to protect the mortgage industry under a mandatory reporting mechanism.

Mr. Chairman, the FBI looks forward to working with you and other members of this committee on solving this problem. I thank you for allowing me the opportunity to testify before you today, and I will be happy to entertain any questions.

Chairman NEY. Thank you for your testimony.

[The prepared statement of Chris Swecker can be found on page 90 in the appendix.]

Chairman NAY. Before we move on to Mr. Weicher, if there are any members who would like to submit their opening statements for the record, without objection, they will be submitted for the record.

Thank you.

Chairman NEY. Mr. Weicher.

STATEMENT OF HON. JOHN C. WEICHER, ASSISTANT SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. WEICHER. Thank you, Chairman Ney, Ranking Member Waters and distinguished members of the subcommittee. And on behalf of Secretary Jackson and the Department, thank you for this opportunity to testify on mortgage fraud.

Today, I would like to provide you with an overview of FHA's initiatives to address this problem.

Predatory practices can take many forms. Lenders that use these tactics often target our most vulnerable populations. Predatory loans harm borrowers by making it impossible or difficult for them to keep up with payments, and if they miss their payments, they risk losing their home, their credit standing and their initial investment.

Predatory lending can rise to the level of criminal activity and constitute mortgage fraud, knowingly undertaken by individuals intent on profiting at the expense of others. Actions include deliberate manipulation of property valuations, falsification of borrower financial information, forgery of licenses, certifications and titles, and misrepresentation of property ownership and conditions.

FHA monitors lenders for program compliance. During the last 4 years, FHA has completed over 3,600 lender monitoring reviews. In about 200 of those reviews, we documented significant findings that may constitute fraud. By statute, FHA refers all potential fraud to HUD's Office of Inspector General. Consequently, FHA made 1,345 referrals to the OIG to investigate findings of possible fraud during this period.

Once we make a referral to the OIG, our role is simply to work with them, providing them with whatever information they may request, such as loan case binders.

Besides working with the OIG, FHA combats mortgage fraud by working to prevent it. In this regard, FHA has made significant efforts through consumer education, regulatory reforms and enforcement actions.

HUD believes that our first line of protection is an informed consumer. Housing counseling has proven to be an extremely localized important activity to educate consumers on how to avoid abusive lending practices. In the last 4 years, President Bush has doubled the budget for housing counseling and Congress has approved. In fiscal year 2004, HUD awarded $36 million in grants to counseling agencies. These grants will assist more than 700,000 people to either become homeowners or remain homeowners.

FHA has also developed new program requirements, specifically targeting lending practices to protect all FHA borrowers. In this administration, we have published eight Final Rules, including an anti-flipping rule and two proposed rules, and we are currently drafting five more. I list these in my prepared statement.

And FHA has put in place a series of procedural changes designed to deter mortgage fraud, also listed in my testimony, such as new guidance on Social Security number verification.

In addition to establishing more stringent procedures for participating in FHA programs, we are taking aggressive action concerning business partners that demonstrate poor performance and abuse of lending practices.

We now monitor appraisers based on the risk they pose to FHA. Under the approach we inherited from the previous administration, FHA spent $46 million over 3 years, but found only 97 appraisers to sanction. Under our new "Appraiser Watch" system, we have spent less than $1 million in the last 3 years and sanctioned over 300 appraisers.

FHA has created "Credit Watch," which tracks quarterly the default rates for the 25,000 lenders that originate FHA loans, and enabled HUD to determine those offices where the default rate significantly exceeds the rate in the local area.

Since "Credit Watch" started 5 years ago, FHA has terminated 261 lender branches. The industry supports "Credit Watch." we sanction the worst performers and create a level playing field for those who follow the rules.

FHA also produces "Neighborhood Watch," a Web-based software application which provides lenders with statistical views of their performance so they can compare themselves to others in their area. "Neighborhood Watch" is also used by community groups to monitor local lenders and by HUD's OIG to identify possible lenders for audit or investigation.

I hope this discussion of our efforts and accomplishments has made clear that the administration and the Department are aggressively policing FHA participants and imposing significant sanctions on business partners found to be engaged in abusive or deceptive behavior. We are firmly committed to protecting customers against mortgage fraud.

Thank you for the opportunity to meet with you today.

[The prepared statement of Hon. John C. Weicher can be found on page 111 in the appendix.]

Chairman NEY. I want to thank all three of the gentlemen for their testimony.

I wanted to ask a question of Mr. Swecker. Do you, with the FBI, just focus most of your time on this, or all of your time, on mortgage fraud?

Mr. SWECKER. Within the Criminal Division?

Chairman NEY. Yes.

Mr. SWECKER. My responsibilities are all criminal—The entire criminal program—so it would include violent crime, white collar, the whole aspect of criminal violations.

Chairman NEY. I want to ask a question on the flipping aspect.

What happens if, you know, a person has, for whatever reason, bought a property at a lower level—maybe there was a divorce, or a person lost their job and they moved out of town or whatever—and they bought it; and then they are going to be owner occupied, so they didn't have to put as much money down.

And then they turn around and find out they can sell it at a lot higher price. But they don't have a fraudulent appraisal; it is not fraudulent, but you know, they buy for 60 and they sell for 90.

Ms. WATERS. It is the American way.

Chairman NEY. I am just wondering.

Mr. SWECKER. That wouldn't fall into the category of property flipping.

Chairman NEY. But if they said they were going to be owner occupied, and all of a sudden somebody came around and said, look, I will give you 20,000 more for that property, would that then be fraud because they said it would be owner occupied, turn around and——

Mr. SWECKER. I think that depends on their intent at the time they make the representation on the application and to the loan originator. I think you would have a hard time proving a criminal intent there.

Chairman NEY. How would you investigate intent?

Mr. SWECKER. Well—you would look at all the facts and circumstances. You know, that type of single transaction is not where our investigative efforts would be focused. We are looking at more systemic-type schemes.

Chairman NEY. Somebody comes in, has a fraudulent appraisal?

Mr. SWECKER. Right.

Chairman NEY. Tries to make it look like the place is worth a lot more?

Mr. SWECKER. That isn't the type of case we would spend a lot of——

Chairman NEY. It is more an organized effort by people to do this on a larger basis?

Mr. SWECKER. Correct,correct.

Chairman NEY. How do you think law enforcement can best, you know, combat—and I know this is not everybody in the industry; you know, I am fully aware of that. And sometimes—the purpose of this hearing today is, a lot of times, the industry are victims. You also have predatory lending, that is, upon a borrower; but in this case, it is fraud coming back up to the lender, which can affect a lot of people.

But how do you think law enforcement can best combat it, working through structures of the institutions, the brokers, the bankers?

Mr. SWECKER. A combination of things. I think education is number one. I think what we have tried to do over the last couple months here is to get some awareness, develop it within the industry, how prevalent the fraud is, combined with some aggressive enforcement action, so that we can get a deterrent out there and deter those would-be fraudsters.

The third part of that is to develop or require some type of reporting system, much like the Bank Secrecy Act requires on other suspicious transactions. Currently, the banks are covered under that, but the mortgage brokers and others in the loan origination process are not required to report any type of suspicious activity.

Chairman NEY. One question I have for any of the panelists, if the origination volumes decline, do you think then the fraud will drop automatically? Does it go hand in hand when there are more originations? If it declines, will this historically drop?

Mr. SWECKER. I think it does go hand in hand, but I am sure that they will have opinions on this as well. But I think the volume itself has created some cover for the unscrupulous professionals that are insiders that are involved in these fraud schemes.

So I think if volume did go down, yes, we might see a reduction in the fraud schemes.

Chairman NEY. Any comments, Mr. Weicher or Mr. Donohue?

Mr. WEICHER. I think Mr. Swecker is right about that. I think fraud will rise and fall with the market, not necessarily proportionally, and the bigger the market the more opportunity there is to perhaps get away with something, given the resources that are available to combat it.

Mr. DONOHUE. Mr. Chairman, I wanted to revisit something you asked a moment ago, and that was the process by which these cases come to be, and the actions—we, the OIG is a bit unique in the fact that not only do we criminally investigate these cases and address the civil side, but we also work with the Department as far as the Department suspensions.

I must commend the department, the aggressive nature; we have worked collaboratively to deal with these things. I do feel, however, these debarments, as egregious as some of them may be, may require a permanent debarment for the industry.

Chairman NEY. A permanent——

Mr. DONOHUE. A permanent debarment. I think some of these matters—some are so egregious, my concern is that the folks that might have caused these problems get back into the industry again, and that is a concern that we have seen in the past.

Chairman NEY. Well, my time has expired.

The gentlelady from California, the ranking member.

Ms. WATERS. Thank you very much, Mr. Chairman.

You know, I am very appreciative of the time and the attention that you give to the subcommittee and the work that you do in organizing hearings so that we can be better informed and make better public policy.

Now I wish I could tell you, Mr. Chairman, that I focused—that this is one of my top priorities, but it is not. I am very interested in predatory lending and foreclosures, and I am very interested in innocent, hard-working people who get caught up in schemes that cause them to lose their homes.

Now I am glad that you straighten out where you put your time and your attention, because I am not interested in a desperate would-be homeowner who inflates their income a bit. I think what they should be told, when they are making application, is that this is a crime and they shouldn't do it. I am not interested in people who make mistakes because they are desperate, and I essentially hope you don't put your time and attention there. And I want you to know that oftentimes lenders and brokers are involved in encouraging people to do things that may be a violation of law, and people innocently follow the advice of their mortgage bankers or brokers and they get in trouble.

So I am not interested in spending a lot of time and attention on catching consumers who are stupid or desperate and make a mistake or sell their home and get caught up in something.

Now if there are organized efforts and schemes where you have, again, the thieves, I guess, or a group organized; and they have a particular way that they are creating crimes—I mean, they are involved with fraud and ripping off, then that is something else. And I didn't know that that was a big problem. I mean, I am worried

about mortgage bankers and brokers who do second and third and fourth mortgages and who flip the loans and increase—and the consumer has no way of paying off those loans. They don't even know who they sell the loans to. Now I consider that more than predatory lending. I consider that a kind of organized fraud, particularly when some of these mortgage companies have a reputation for doing that.

So, I mean, if this committee hearing today, Mr. Chairman, is about fraud that has been committed by innocent people who fall into these schemes who are desperate and who make mistakes, I have got to go. But if it is something else, I will try to stick around.

I don't know what to ask you. What are you doing here? What do you have to tell us?

Chairman NEY. We would like to have you either way, here, but, you know, we will see what he says.

Ms. WATERS. I would like to stay, but——

Mr. SWECKER. I would like for you to stay.

We don't focus our resources on the individual, unwitting borrower who has been sort of caught up in a scheme. Our focus is on the industry insiders. I mentioned the two types of frauds, fraud for housing, fraud for profit. Most of our efforts are focused on the fraud-for-profit type of violation.

We are looking for something that is more systemic than just an unwitting individual borrower who has been caught up in a situation. Maybe they went along with it because they were unsophisticated, but that is not our focus at all. We don't have the resources to engage in that type of single transaction investigation. Our focus is clearly on the insiders and the schemes.

Ms. WATERS. I want you to know that my staff also focused on flipping, and it is not the kind of flipping that I normally talk about. I talk about flipping by the lenders who flip the loans and increase the interest rates and all of that. They kind of focused on flipping in terms of buying properties, putting some paint on them and fixing them up and putting them back on the market.

Mr. SWECKER. Right.

Ms. WATERS. Now, again, you know, I am not sure that that is fraud as they have been describing it to me. You know, it is kind of the American way. You buy something cheap and you sell it for more and you make a property—and, as I understand it, that house that you fix up will not sell for more than the market will bear in the neighborhood where you are selling it. So if you buy a rundown piece of property in a neighborhood where the houses are selling for $200,000, and you pay, you know, $75,000 for it and you fix it up, and you sell it for $200,000, I don't consider that fraud. You know, and I—you know, I discussed that with my staff.

Is there something in that kind of flipping that I don't know about that you consider fraud?

Mr. SWECKER. What you describe is not fraud. I can't speak for HUD, but I think I know what they would say and will say. We don't focus on those individual quick transactions where somebody has worked hard, put some sweat equity in the house and made a profit. That is not where our resources are going to go. Our resources are going to go, as I said, on the industry insiders. If somebody has consented to be a straw buyer, that is a different story.

Ms. WATERS. I don't want to exceed my time, but if you could give me one example of what you do, what you are talking about. Who are you trying to catch?

Mr. DONOHUE. Would you like me to—Chairwoman, a perfect example of this is when we see a pattern in the southwest part of the United States, when we see folks come in across the border and come in to buy, you know, come in to experience the good life. And what happens is they are often approached by suspected wrongdoers that go back up and suggest that they can get into a house, and they get into it for a great price. And they occupy these homes—and, of course, many of these people are already illegal immigrants into this country. They get into these units, the information is provided to them, often fraudulent information, fraudulent Social Security numbers and the rest, false information about earnings and the rest. And what happens, they get into these units—and there is quite a number of these cases.

Our focus, as the FBI has just spoken about, is not on those individuals occupying those units. The focus is on the people who are gaining the ill-gotten proceeds from that event.

We often call upon those very arguments as witnesses for our cases involved. That is the focus. That is—it is a substantial amount of that. It goes on; and, quite frankly, some of these people occupy those homes and stay in those homes for some period of time and paying on those mortgages——

Ms. WATERS. How many of those kinds of cases have you prosecuted?

Mr. SWECKER. All the cases, the examples that we have given, are cases involving insiders, where there has either been a fraudulent appraisal or there has been some type of fraud or fraudulent act on the part of insider. So in the circumstances you are describing, only if they had got a fraudulent appraisal would you see us go after somebody who was just trying to put some sweat equity into a house and make a profit on a piece of real estate. And that—again, we are not focused on the borrower. We are focused on the insider engaged in criminal acts.

Ms. WATERS. I know, but, unfortunately, I haven't seen a lot of prosecutions. For years we have been fighting against mortgage brokers and maybe bankers or folks who falsify on behalf of these unsuspecting people, tell them what to write down. They are usually charging them too much money, too many fees, and they are the ones who get foreclosed on. But those guys never get prosecuted. I mean, I have worked some of these cases for 4 to 5 years in my district, and we have a consumer division in the District of Attorney's Office, but they just can't seem to catch these characters.

So that is all I would be interested in, is how to get the guys who are putting people into homes with false information, overcharging them, too many fees, too high interest rates, everything, foreclose on them after they flipped the loans, sold the loans. We can't even find them. So when you all have information about how you catch those, let me know.

Thank you.

Chairman NEY. I thank the gentlelady.

The gentlelady from Pennsylvania.

Ms. HART. Mr. Chairman, I believe Mr. Miller has some time constraints, so I am going to cede to him.

Mr. MILLER OF CALIFORNIA. Yes, thank you.

I have been involved in development for over 30 years, and the question was how many of these have you caught—and when I first went into business as a young contractor I did a lot of HUD work, and the difficulty we have we refer to the MAI appraisals as Made As Instructed. And it is very, very simple for an individual to buy a $210,000 home, have a connection with a broker or an appraiser, and an appraiser will come back with an appraisal for $235,000 that might be inflated $25,000.

But that inflation on your part is very, very, very hard to prove. Because an aggressive appraiser can justify most anything they want within 10 percent. If they are really creative, I have seen it to exceed 10 percent very easily; and for you to come back and say they committed fraud is very difficult.

But that is the area that I have a huge concern with. Because the minute we start selling properties—as we are looking at this real cost of mortgage fraud—you are selling a piece of property that is worth $210,000, and it sold for 235. Somebody made 25 grand in costs plus—and fees. You take it back, and you have lost money on it, and then your cost of putting that piece of property back on the market becomes a very, very expensive process for the system. When something is expensive for the system, it costs everybody involved in the system.

And there is a lot of ways of committing fraud. Putting paint back on a house, putting a latex over a lead-based paint is a felony, committing a fraud against somebody in the future. So, yes, even painting a home can be fraud and leaving somebody with a very expensive process in the future.

I guess my biggest concern in what was said—and I guess, maybe I heard it wrong, but why would anybody be allowed to be involved in the process being considered an acceptable vendor, whether it be an appraiser, broker or builder—if they have been found to be guilty of fraud at some point in time, why would, at some point in time in the future, would they even be reconsidered to be involved in the process? Did I misunderstand what was said?

Mr. DONOHUE. Well, I will respond in that one of the processes in which we—to step back, if we could, to the criminal case itself—or to the civil case—we work with the FHA and a mortgage review board to look at the sanctions that could be moved against these folks involved as quickly as we possibly can.

And I might say we do have an aggressive—the Department has been aggressive in addressing these matters. I just—my comment was that I think in some of these cases—which I feel to be egregious cases—is my feeling is that these folks that might have been involved should be removed, if not permanently from the industry then substantially so.

Mr. MILLER OF CALIFORNIA. I think it should be permanently.

You know, the problem I have with builders is when they start saying it is acceptable industry standards there is generally something wrong in what they have done. If they have to justify their quality of construction by this is the accepted industry standards,

generally you have found out that that is probably a builder nobody wants any involvement with.

And any type of fraud is bad. I mean, I am shocked that any of us up here would say, well, this kind of fraud doesn't bother me, that kind of fraud doesn't bother me. There can't be degrees of fraud. Fraud is fraud.

Now if you have an unwitting individual that did something, and they didn't know they were doing it, they were not aware, that happens. But anyone who commits fraud, represents himself to be a brother who doesn't have the wherewithal to make a payment just to get in the home is fraud. And when that house is foreclosed upon, somebody else is going to have to pick up the burden because they are paying the fees. So any fraud in the system impacts innocent people who want to be involved in the system.

I remember when I was a young builder, I did HUD work in east L.A. I used to go out and bid these HUD prosecutions, and I would be awarded a contract. All of a sudden, my partner was called in by the director of the HUD in the region saying he wanted a third of our profits back in cash upon issuance of the contract. Now he didn't call me in. He didn't call anybody but my partner. We were young. I said, we are not going to give anybody a kickback. We are low bidder. You have to continue to give us the contracts.

Yes, we continued to be a low bidder, but, for some reason, there was always something found wrong with the RFP. The award we should have received on the contract was put out to bid with somebody else, and we were off bidding another job, so—and I don't think that is probably as predominant today as it has been at some times over the years. But there is all types of fraud, whether it be involved in our system or within the builder, appraiser or broker system.

But any time we—and your job is very difficult. I don't know how—unless it is something very, very egregious where you can go to court and prove fraud—it is very difficult with an appraiser, like I said, anywhere within a realm. And if there is any association between a broker builder and an appraiser, the system will be impacted in a negative fashion through fraud that is very difficult to prove. You might suspect individuals of having problems, but to prove it is very, very difficult.

But I think this is an issue that erodes the system, and I think it is something that—if we are allowing people who have been found guilty of fraud to reenter the system and be acceptable, I think maybe we should look at that.

But thank you for your efforts. I would encourage you. This is an area we need to effectively deal with.

Thank you. I yield back.

Chairman NEY. Thank you.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Mr. Donohue, in your testimony, you talked about the 158-count indictment in the Northern District of Georgia concerning flipping. Could you give me an update on where we are on that case?

Mr. DONOHUE. If you don't mind, I am going to have my—I was going to have my head of investigation come up here, but he just

advised me that the case is still open and for that I am prevented from getting into specifics at this time.

Mr. SCOTT. Okay. Could you give an indication as to why Georgia has just catapulted to the front on this issue? What is peculiar? What are the circumstances in Georgia that have allowed it to get to the head of the class on this?

Mr. SWECKER. You know, the figures that we have are based on an intelligence assessment that we have done which relied heavily on private industry, such as the Mortgage Asset Research Institute.

I can't tell you why Georgia is in there. It may be just volume of transactions—and as we mentioned earlier, within that volume, it provides cover for the unscrupulous brokers and appraisers and others that are willing to commit fraud. So it may just be a function of the volume.

Mr. SCOTT. Mr. Swecker, is that right? Swecker?

Mr. SWECKER. Yes.

Mr. SCOTT. Concerning the FBI, you mention in your testimony that the mortgage fraud in the secondary market is often underreported, so the two-level mortgage fraud is largely unknown, that the mortgage industry itself does not provide estimates on the total industry fraud and that the industry provides incomplete and inconsistent data. And yet you say mortgage fraud is pervasive and growing and that, for the past 18 months, you all have been doing an internal valuation of the FBI in terms of your effectiveness. Could you tell me what you are finding out in terms of your effectiveness and specifically what level of funding is currently allocated to the FBI toward mortgage fraud?

Mr. SWECKER. I am not sure about the level of funding. I would have to get back to you on that.

But I can tell you I think our efforts have been very successful. We are trying to provide a very visible deterrent along with HUD and other investigative agencies. We are trying to get the word out there that these schemes are out there. If you get caught, you are going to go to jail, and we are hoping that we will have some deterrent effect.

We have been very aggressive with undercover operations. This started about two to two and a half years ago—and at that time I was the agent in charge in North Carolina. We saw an immediate spike as the interest rates went down in mortgage fraud schemes.

As I mentioned earlier, I think there is a lot of cover provided in just the volume, and it is a very competitive industry. The mortgage broker industry, loan originations are very lucrative. I think in all of that volume we have just seen some unscrupulous people set up brokerages that are devoted, in some cases, almost exclusively to fraudulent schemes, and then they disappear after the house of cards starts to come down.

But the reason we came out with our press statement about 2 weeks ago, we wanted to get some education out to the industry and public. We wanted to develop some awareness and provide some deterrent to see if we could get this problem—talk this problem down in a sense.

We have created a mortgage fraud initiative nationwide, where we have all of our field offices looking for this type of fraud, not individual borrowers, unwitting folks who have been caught up in

a scheme, but more the systemic fraud schemes where we have 100, 200, 300 frauds being perpetrated by one company.

Mr. SCOTT. What can we in Congress do to help the FBI expand these investigations?

Mr. SWECKER. What I mentioned about reporting requirements, if we could extend the reporting requirements to the entire mortgage industry, not just the banking institutions themselves. There are a lot of other types of mortgage-related businesses. If they were required to report and if you were to give them the safe harbor provision, then we would be able to identify these schemes and address them.

Mr. SCOTT. Thank you.

I yield back the balance of my time, Mr. Chair.

Chairman NEY. I thank the gentleman.

The gentleman from Arizona.

Mr. RENZI. Thank you, Mr. Chairman.

I have a little favor to ask, Mr. Weicher, and I apologize. It is not so much fraud related.

You made a statement that your organization did a hell of a job recently to reacting to an issue in Arizona. Myself and Congressman Shadegg sent your department a letter. We have got one of these down-state assistant providers in Arizona called Family Housing Resources. They were removed from the Web site, removed from a list of assistant providers.

When you get back—I haven't seen you in so long—if you get a chance could you go down in your Department and reach down and grab this issue and see if we can resolve and get these guys back in shape? We have got 2,100 Arizonans who benefited these—award-winning people, nothing to do with fraud.

But it is good to see you here, and I thank you for the work.

Mr. WEICHER. I thank you, Mr. Renzi. We will be getting back to you on this, we expect, next week. We are aware of the issue. I will go back and have appropriate conversations, but we are expecting to be able to get it—to deal with it by next week.

Chairman NEY. The gentlelady from Indiana.

Ms. CARSON. Thank you very much, the three of you, for being here.

I am Julia Carson from Indianapolis, Indiana. You had mentioned that you are doing some work out in the Midwest, and I would also think that would be Indianapolis.

Indianapolis had one of the highest rates, if not the highest rates, of predatory lending and foreclosures in the whole Nation. I am sure you are aware of that. We have had extensive town hall meetings to try to pinpoint the problem. There is no one particular entity that seems to be the problem. You have got real estate agents, you have got mortgage brokers, you have appraisers who seemingly have been engaged in this whole fraud issue. Inflated appraisal prices, humongous foreclosure rates, predatory lending against everybody, not just senior citizens or those who are of a low income.

They will use techniques to inflate the prices, get some of the money from the bank, pay off the home buyer, and then the home buyer is stuck with repaying that money plus others.

I was wondering if somebody could tell me if it is appropriate, it may not be, what your opinion is on this free payment, home down payment for home buyers, and if you have had any experience with this group called Nehemiah. They seemed to have worked extensively in my district. If you cannot answer, I respect that, because that is a policy question.

Mr. WEICHER. Ms. Carson, we permit down payment assistance in the FHA program, and Nehemiah is one of the nonprofit entities which provides down payment assistance. We have been reviewing, and the Office of Inspector General earlier working with us have been reviewing, the experience that we are having with the loans that have down payment assistance, and have been conducting an investigation and analysis really of our loan experience with down payment assistance.

Ms. CARSON. Have you investigated Nehemiah specifically?

Mr. WEICHER. I think "investigation" is the wrong word. I misspoke. We analyze our experience with the loans, what the default rates are, comparative default rates, with loans that do not have down payment assistance to see if there are changes that would be appropriate to make in the program.

Ms. CARSON. I have long held the view, I am in the minority with this view, but that not everybody should be a homeowner.

Number two, we created a help line that got over 800 calls initially. It is called 1-800-722-HELP, and that is when people are about to sign their name on a paper buying a home, nobody reads that fine print up and down the line, that tiny writing for the most part. If you have 2 or 3 weeks to read it, that is different. So we have volunteers funded by Fannie Mae where the credit bureaus are checking out applications before people sign their name to a long-term commitment in terms of buying houses, and it has worked extremely well. As a matter of fact, we have to see if we can get more staff to handle those inquiries prior to the time people sign their names.

In this whole mortgage field, predatory lending, it is not isolated. It is not one group or the other. I guess you call it the buddy program, they are all involved in this mess together. I would hope you would do something that is high profile, that would discourage future events, but I don't know how that would work. People rob banks every day. Robbing banks is high profile, but they still rob banks. Maybe with your creative collective minds you can come with up something, because consumers are being injured immensely by all of this.

Mr. DONOHUE. Congresswoman Carson, I have been advised the OIG did an audit of Nehemiah for 2 years, and we can get you a copy of that.

Ms. CARSON. I would appreciate that.

Mr. SWECKER. I would like to quickly address this issue, the borrowers are often the victims. That is exactly the type of violation we are looking for is a scheme that affects multiple loans. What you are describing is an area where the FBI would apply some resources to investigate. We are aware of Nehemiah. There are several field offices that have received information about some of the things that they have been involved in. I could not discuss what

we are doing with it because it is ongoing, but we are aware of the group.

Mr. MILLER OF CALIFORNIA. Would the gentlewoman yield?

I have been involved with quite a few nonprofits, and HUD stays on top of them. I am not speaking to Nehemiah, but I have known many others who have come in with questions and concerns on how HUD really has diligent oversight. HUD watches the resales. They watch those. If there is discrepancies, they watch those.

Ms. CARSON. But you take a name like Nehemiah, anybody that goes to church is going to trust Nehemiah. You know what I am saying.

Mr. MILLER OF CALIFORNIA. I have heard about some companies, they get involved with an appraiser, a broker and a builder. When that happens, that, to my previous comment, makes it very difficult; but how do you prove there has not been an inflation of $25,000 in an appraisal? That comes over to nonprofits also.

Mr. NEY. Thank you.

Ms. Velazquez.

Ms. VELAZQUEZ. Mr. Swecker, one of the difficult things about tracking unscrupulous individuals engaging in mortgage fraud is they move from company to company and their histories on loans to new employers, and they begin to take advantage of families again. The creation of a national database has been raised as a way to curb fraud and protect unsuspecting families. Can you comment on this suggestion and the possible pros and cons of such a database?

Mr. SWECKER. I think that plays into the reporting requirement.

Ms. VELAZQUEZ. I am so cautious when it comes to the Federal Government and a database.

Mr. SWECKER. That would be the best mechanism, or some type of fraud reporting center. We would love to have the information. We could do a lot with it. We use a lot of computer analysis right now with the existing SAR process, and we are getting a lot of case initiations off that.

The debarment process is something that HUD and some of the regulatory agencies are involved in, and I would defer that question to Mr. Donohue.

Mr. DONOHUE. It needs to be said that by a fact regulation, when the FBI comes upon an investigation involving FHA fraud, they advise us. We in turn, involving commercial fraud, advise them. It is a statement to the cooperation.

Finally, organizations like the MBA and so on have been very active lately in passing on information to us with regard to wrongdoers. The communication link is there and getting better as we go along.

We look at these debarments and suspensions activities rather well. There is an awful lot of discussion going on as to try and see if we can make sure these names are provided for. We at HUD are pretty pleased with getting heads up with regard to folks that go back in. I feel we cannot do enough in ensuring, as the Congresswoman said, staying on top of these things and making sure the same people do not come back in.

Ms. VELAZQUEZ. Thank you.

Mr. Weicher.

Mr. WEICHER. We are in the process of developing a rule now for FHA programs establishing a loan officer registry which will increase our ability to monitor the performance of loan originators. It will help us track loan officers, unscrupulous loan officers, as they move from company to company. That is in the development stage. It is not yet a proposed rule, but we are working on it, and we think it will be useful.

Ms. VELAZQUEZ. Mr. Weicher, the foreclosure rate of 11.68 percent on FHA loans exceeds the national foreclosure rate by 7.35 percent. This figure is alarming, and HUD needs to do more to protect families from unscrupulous lenders abusing this program. We will hear later from Ms. Amiri from the Foreclosure Prevention Program of South Brooklyn Legal Services, who serves families in my district. There are several interesting suggestions in her testimony that I want to hear your thoughts on.

First, can you comment on her recommendation that HUD should commission an independent appraisal or appraisal review for every transaction to ensure the accuracy of the market value of the property and to prevent fraudulent appraisal?

Mr. WEICHER. Ms. Velazquez, I think if we were to commission a separate appraisal beyond the appraisal that is required as part of the loan application, we would be spending a great deal of time and funds.

Ms. VELAZQUEZ. And we would be saving a lot of families' homes, too.

Mr. WEICHER. We have established a system whereby we track the performance of the appraisers who do business with us. We know the name of every appraiser on every loan. There are 25,000 appraisers who have the authority to write appraisals on FHA loans. We track the performance of the loans on which they have done appraisals. We look at the early default rates on those loans, because if there is something wrong at the front end, if there is something wrong in terms of predatory lending or a corrupt appraisal, it is very likely to show up in the first year or two after the loan has been performed. We look at the performance of each appraiser over the first year or two on the business they are doing, and if their performance is out of line with the normal default rate in their area, we sanction them. We throw them out of the program.

In the 3 years we have been doing this, we have removed over 300 appraisers from FHA's program. That is a little over 1 percent of all of the appraisers who do business with us, but we have the attention of the appraisal industry. I hear often from appraisers and from appraisal organizations about the way that Appraiser Watch is working.

Ms. VELAZQUEZ. I can see that when you have 11 percent on FHA loans that exceeds the national rate.

Mr. WEICHER. That is the 30-day delinquency rate.

Ms. VELAZQUEZ. She also suggests that HUD should extend the prohibition on resale from 90 days to 6 months. What are your thoughts about that?

Mr. WEICHER. This is the antiflipping rule that I mentioned whereby we will not insure a mortgage if the home has been sold

twice within 90 days, and if the period between sales is between 3 months and 9 months.

Mr. NEY. I have to get the other two Members in before the vote. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

I thank the witnesses for being here. They probably think they walked into a combat zone. They came expecting to be patted on the back and applauded for what they are doing. Actually they do need to be applauded for what they are doing because this is an important part of what is going on in the industry. Unfortunately, you walked into a committee that recognizes the magnitude of the problem that you are dealing with, which is, in effect, efforts to defraud lenders pales in magnitude when you look at its volume compared to the extent of predatory lending.

This is protecting lenders from people who are defrauding lenders primarily, which is what you are talking about. But on the other side is a category of predatory lending that is of enormous magnitude, and that is what this committee has focused a lot of its attention on. Part of that goes to, just to illustrate the point that I am making, the definition of industry insiders that is set out on page 3 of Mr. Swecker's testimony. It does not include, except tangentially, I guess you could say, other mortgage professionals engaged in the mortgage industry.

So essentially what you all are doing is protecting lenders from unscrupulous people, which is an extremely important part of protecting the integrity of the system. But when you talk about seven plea agreements on page 6 of your testimony, Mr. Swecker, and we see probably seven predatory loans being made in an hour in that same Charlotte market that you have described, and what you walked into is not a reflection on the value of what you are doing, it is a reflection on the magnitude of our concern about what is going on on the lender side where people are being charged higher interest rates than they should be charged, where lenders are flipping the loans to get more origination fees and what have you.

I don't want you to go away from here discouraged, I am just trying to put this in perspective for you. There is a much, much greater in magnitude problem on the lender side than the one that you have identified here. I am trying to put that in perspective for you.

Second, I want to just make clear that nobody goes away thinking that all Nehemiah organizations are terrible people. Nehemiah organizations are all over the United States, and I suspect the quality of what they are doing varies from locale to locale. The Nehemiah organization in my congressional district, for example, I think, has done some commendable work. And I don't know what is going on in Indianapolis with Nehemiah, but I do not want folks to leave here thinking we have indicted the whole Nehemiah organization.

I don't really have any questions. I think the work you are doing is commendable. It is necessary. I would like to see an equivalent fraud unit focusing its attention on predatory loans, which are not by definition fraudulent loans. There is a whole different standard apparently.

With that I yield back.

Mr. NEY. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Weicher, Mr. Miller made an interesting point earlier that wrongdoing is wrongdoing, and he did not like this distinction that some Members were drawing between fraud aimed at borrowers and fraud aimed at lenders. His point was wrongdoing is wrongdoing. Let me follow that to its logical conclusion.

We have considered and are considering on the floor this week a bill that would name companies in this country that do business with terrorists or who do business or financing with organizations connected to terrorists. We also in this country have a practice of naming companies who trade with sanctioned nations like Libya or Iran or Iraq. We are going to publish a list, I believe, next week of companies who have traded with sanctioned nations.

Under Mr. Miller's premise that wrongdoing is wrongdoing, how do you feel about the idea of HUD publishing a list of companies that regularly engage in predatory lending?

Mr. WEICHER. We do that now. We publish in the Federal Register the names of the entities who we sanction through the Mortgagee Review Board, which I chair at HUD, and which consists of six assistant secretaries and the director of the enforcement center. We review cases of predatory lending, of carelessness, of failure to follow our rules.

Mr. DAVIS. Do you just name people that you sanction, or do you try to quantify people who regularly engage in the practice, because they are two different things?

Mr. WEICHER. We name the people that we sanction. We name the penalty that is being imposed at the same time. Some of those are civil money penalties, and the dollars relate to the severity of the violations. And we suspend or debar for 3 years, 5 years, or indefinitely the most egregious offenders, and we publish that information as well.

Mr. DAVIS. Mr. Swecker, I spent 4 years as an assistant U.S. Attorney in Alabama, and certainly admire the work that the Bureau does in this area. When I was with the U.S. Attorney's Office, we regularly worked with our State attorney general and regularly worked with State agencies to combat all kinds of crime in the white collar and violent crime areas. Is it helpful to the FBI if State agencies and State attorneys general are themselves allowed to regulate and get involved in the area of mortgage fraud and predatory lending?

Mr. SWECKER. Yes.

Mr. DAVIS. As you know, one of the controversies that we regularly have in this body are the degree to which States are to be given an opportunity to regulate in this area, the degree to which States have an opportunity to be a laboratory and to police unfair predatory lending practices. Would you agree it is helpful to law enforcement if States have an opportunity to have a robust structure in this area to look for violations?

Mr. SWECKER. Absolutely.

Mr. DAVIS. Thank you.

Mr. Chairman, since this is the last hearing of the year, as a new member, let me thank you for your leadership and for your example in the 108th Congress.

Mr. NEY. Thank you. And I thank you for your constant attendance at the hearings.

We will dismiss the first panel, and recess for the votes on the floor. We will convene the second panel after this break.

[Recess.]

Mr. NEY. I want to thank the panel for your indulgence. I was also waiting to see if another Member would show up. I will go ahead and begin hearing the opening statements. We appreciate you being with us today.

On panel two we have Mr. William Matthews, vice president and general manager, Mortgage Asset Research Institute, Reston, Virginia; Ms. Marta T. McCall, senior vice president, risk management, American Mortgage Network, on behalf of the Mortgage Bankers Association; Mr. Arthur J. Prieston, chairman, The Prieston Group, San Rafael, California; Ms. Brigitte Amiri, staff attorney, South Brooklyn Legal Services, Brooklyn, New York; and Ms. Ecima Trujillo, national field director of ACORN Housing Corporation, Los Angeles, California.

We will start with Mr. Matthews.

STATEMENT OF WILLIAM MATTHEWS, VICE PRESIDENT AND GENERAL MANAGER, MORTGAGE ASSET RESEARCH INSTITUTE, INC., RESTON, VIRGINIA

Mr. MATTHEWS. Chairman Ney and Ranking Member Waters and members of the subcommittee, I am pleased to be here today to talk about mortgage fraud. The Mortgage Asset Research Institute, also known as MARI, builds and maintains cooperative databases in the mortgage industry and is used by financial institutions to screen new business relationships.

MARI was founded in 1990 and was acquired by ChoicePoint Services in June of 2003. One of MARI's cooperative databases is called the Mortgage Industry Data Exchange, or MIDEX. This database was established on the premise that unethical and illegal activities in the residential mortgage industry could be significantly reduced through the responsible exchange of information on mortgage lenders, investors and insurers.

The MIDEX database is cooperative in nature and contains different types of information. First of all, it has nonpublic incidents of alleged fraud or material misrepresentation and serious misconduct by mortgage industry professionals and companies. These incidents are contributed by members of the cooperative database and include over 400 lenders, mortgage insurance companies and mortgage investors.

The second type of data we have is public sanctions and legal actions. These are collected from over 200 Federal and State regulators in the mortgage, securities, commercial banking, real estate and appraisal industries.

The third type of data more positive in nature, is State and Federal licensure data on mortgage companies and professionals.

Today, thousands of companies and professionals are searched each day through MARI's MIDEX database by its subscribers to screen prospective and existing business relationships in order not to do business with unscrupulous individuals and companies.

The topic today is mortgage fraud, and a basic definition of mortgage fraud is when a consumer or professional intentionally causes the financial entity to either fund, purchase or insure a mortgage loan when the entity would not have otherwise done so if it had possessed the correct information.

We have heard by other testimony in the first panel that there are different types of fraud, and people defined it as fraud for property and fraud for profit. I would expand that to say there is consumer fraud, fraud for property. There are also two types of fraud for profit. One is commission fraud. This is where one or more industry professionals misrepresent information in a loan transaction in order to receive a commission. Commission fraud is a more common practice in the industry and is a concern to mortgage lenders. It can result in harm not only to consumers but to lenders as well.

The third type of mortgage fraud is fraud for profit and consists of systematic collision by industry professionals to steal a significant amount of funds from mortgage companies. This type of fraud usually involves multiple properties and parties in various disciplines within the mortgage industry, such as: mortgage originators, appraisers, real estate agents, closing agents, builders and title companies. Fraud for profit usually results in significant, if not catastrophic, losses to financial entities.

Let me give a quick example of mortgage fraud that we see in our MIDEX database. It typifies some of the problems that people are having in the industry. In 1997, the National Association of Securities Dealers (NASD) debarred and sanctioned an individual for taking investor funds of $10,000 and converting those to his own personal use. Since this individual could no longer be a stockbroker. He became a loan officer with a national lender. At the same time he set up his own mortgage company, unbeknownst to his employer.

It turned out that the employer examined over 500 loans originated by this individual, 20 percent of which had inflated appraisals resulting in losses to the financial institution of approximately $2.5 million. In August 2002, this individual pled guilty to wire fraud and received a sentence of 5 years probation and no jail time.

This incident illustrates the need for proper hiring procedures in the mortgage industry and a central repository to track professionals who are found guilty of fraud or unethical behavior in the industry.

Our MIDEX database has a significant amount of information in it, and I would like to point out some of the trends that we are seeing of alleged fraud or material misrepresentation in the mortgage industry. These trends were derived from submissions from our subscribers. First of all, during the past 4 years there has been a shift in the States with the greatest problems. Georgia and Nevada have caught up and surpassed California and Florida as the States with the highest fraud scores. In the past, fraud rates from California and Florida have led the Nation by substantial margins. They continue to have high fraud scores, but Florida now ranks third, and California has slipped to eighth place behind Utah, South Carolina, Colorado and Illinois.

The second trend is early payment default data information from a company out of San Francisco called Loan Performance. This in-

formation indicates that problems in several metropolitan areas are consistent with the overall results that MARI database subscribers have reported to us. Early payment default is defined as a loan that is 90 days or more delinquent within the first year of that loan.

The third trend, the types of problems found in loan files such as false verifications of employment, inflated appraisals, land flips, et cetera, seems to have been relatively stable over the last 4 years.

I appreciate the opportunity to testify on MARI's behalf regarding the impact of mortgage fraud and its impact on the mortgage industry. Fraud is a significant problem, and the types of fraud are increasing, and the types of fraud that are occurring are becoming more severe. Fraud not only causes losses to financial institutions—it can devastate neighborhoods, and it can also result in higher prices to consumers. Thank you.

Mr. NEY. Thank you, Mr. Matthews.

[The prepared statement of William Matthews can be found on page 63 in the appendix.]

Mr. NEY. Ms. McCall.

STATEMENT OF MARTA T. McCALL, SENIOR VICE PRESIDENT, RISK MANAGEMENT, AMERICAN MORTGAGE NETWORK, SAN DIEGO, CALIFORNIA, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION

Ms. MCCALL. Good morning, Mr. Chairman and subcommittee members. As stated earlier, my name is Marta McCall, and I am the senior vice president for risk management at American Mortgage Network in San Diego, California, a wholesale lender that deals nationally. I am here today on behalf of the Mortgage Bankers Association, and I would like to thank you for inviting MBA to testify on the growing problem of fraud committed against mortgage lenders and the threat it poses to our real estate finance system.

Addressing fraud is not easy, but MBA believes that the industry needs stronger enforcement, better communication, and increased innovation if it is to protect the system from the costly damage of mortgage fraud. Residential mortgage finance in the U.S. has developed from a relatively localized system with few participants to one with many specialized organizations working interdependently to make the efficient and low-cost delivery of home loans possible. Consumers have been the primary beneficiaries of this change as more mortgage products are reaching more home buyers than ever before.

Mortgage bankers play a central role in this system allowing funds to flow from the capital markets to consumers. Lenders underwrite loans, then extend credit on terms and conditions appropriate for the level of risk involved. In this capacity mortgage bankers bear nearly all of the risk of mortgage fraud. Simply defined, mortgage fraud is the giving of false information that deceives a lender into extending credit beyond the limits of what would normally be extended if the true facts were known.

Lenders, because they advance large sums, can lose significant amounts of money. Mortgage fraud costs the industry and consumers millions of dollars each year. While no reliable numbers are

available to measure the extent of mortgage fraud, the trend data that is available is troubling. The FBI reports a fivefold increase in mortgage fraud investigations from 2001 through 2004.

Fraud schemes are as varied as the imagination of those who commit them, oftentimes orchestrated by industry insiders who know how to exploit the system at the expense of lenders and, depending on the type of fraud, at the expense of taxpayers, consumers and communities.

Lenders spend large amounts of money and resources attempting to detect and prevent mortgage fraud. Despite these efforts, they continue to find themselves victimized by fraud. I would like to advance three principles the MBA believes would improve lenders' ability to manage the costs of fraud.

First, investigation and prosecution of mortgage fraud by law enforcement agencies needs to increase. Mortgage lenders victimized by fraud are more than willing to provide information and assist in the investigation of the fraud they uncover, but these same lenders get frustrated when cases are not prosecuted.

Secondly, communication between mortgage lenders and the State and Federal agencies that investigate and prosecute mortgage fraud needs to improve. The current system of mortgage fraud reporting is a one-way street. Mortgage lenders report fraud, but rarely receive feedback about their reports. I would however, like to note that the FBI is working closely with the MBA in discussing solutions to this problem.

Finally, the mortgage industry needs to continue to develop better industry tools and improve lender communication to combat fraud. We need the help of policymakers in furthering these tools and communication.

I would like to highlight three issues as examples of the problems lenders face in this regard. First, many States have licensing laws whose purpose in part is to track loan officers, brokers and appraisers. Unfortunately, there is a lack of uniformity among these State efforts, which can lead to loopholes that criminals can exploit by moving from one State to another.

Secondly, communication between mortgage lenders is hampered by the fear of lawsuits if one company discloses to another the results of its investigations. Some form of safe harbor is critical for the type of communication necessary for lenders to protect themselves and consumers from fraud.

Finally, unlike credit and economic risk, the responsibility for mortgage fraud is borne fully by mortgage lenders. Investors require the repurchase of loans when fraud is discovered, but lenders have no practical recourse to those who commit fraud as the offenders are either out of business, have little capital from which to compensate the lender, or cannot be located.

These are just three examples of the issue that MBA is grappling with in helping the industry develop the tools needed to protect lenders, taxpayers, consumers and communities from the potentially devastating effects of mortgage fraud.

Thank you for the opportunity to testify here today. The mortgage industry looks forward to working with Congress, Federal and State agencies in furthering collective efforts to combat mortgage fraud.

Mr. NEY. Thank you.

[The prepared statement of Marta T. McCall can be found on page 72 in the appendix.]

Mr. NEY. Mr. Prieston.

STATEMENT OF ARTHUR J. PRIESTON, CHAIRMAN, THE PRIESTON GROUP, SAN RAFAEL, CALIFORNIA

Mr. PRIESTON. Good morning, Chairman Ney, Congresswoman Waters, and members of the committee. My name is Arthur Prieston. I am chairman of The Prieston Group, partner of the Mortgage Banking Group of the law firm of Lanahan & Reilly in California. I have been involved in the mortgage industry my entire professional life, first as an attorney specializing in mortgage fraud civil prosecution, and now as a provider of an integrated suite of mortgage fraud protection, mitigation and indemnification services in the industry.

Our companies protect hundreds of lenders around the country with mortgage prefunding quality control and due diligence; fraud detection and prevention training; and ongoing education in quality lending and best business practices. Through our insurance division, TPG protects against fraud with our lender representation and warranty insurance coverage.

Through our law firm affiliation, we mitigate losses associated with mortgage fraud. We have the most experienced mortgage banking staff in the country, and they specialize in loss mitigation, fraud investigation and recovery analysis.

In the past 2 years the combined resources of The Prieston Group are protecting over $50 billion in residential loans, and have resolved and/or paid in excess of $40 million in losses due to mortgage fraud on behalf of our clients, making TPG the largest mortgage fraud service provider in the Nation. We are in the trenches. The pervasiveness of mortgage fraud and its increasing impact on our industry is a direct consequence of the extraordinary speed of growth and demand on the real estate financing delivery system that is both complex and faceless.

At the same time, the remedies available to address these attacks on lenders and borrowers by sophisticated mortgage fraudsters are antiquated and ineffectual. Complex mortgage fraud schemes, the most damaging, are necessarily dependent on third parties to the transaction. It is these parties, such as appraisers and settlement agents, among others, who can, if held accountable, prevent mortgage fraud, but in many cases have no liability for losses due to mortgage fraud.

The extent of mortgage fraud—and we have talked about statistics throughout some of the testimony heard today, discussing numbers such as 10 percent of all loan applications is commonly quoted and accepted as fact, but the truth of the matter is the industry has been unable to unequivocally substantiate that statistic. The extent of fraud varies depending on geographic location, origination channel of the loan, the lender's commitment to quality originations, and the accountability of all participants in the transaction.

Historically we know that a high propensity of fraud occurs in urban markets. The more notable markets at the current time in-

clude Chicago, Cleveland, Atlanta, Salt Lake City, Brooklyn and Detroit, to name just a few.

Mortgage fraud is not only here to stay, its incidence is becoming more widespread. Within the experience of The Prieston Group, our insurance and legal claims have risen over 40 percent in the last year. We believe this is attributable to an increased awareness of successful methods and techniques to commit fraud. Left unabated, we believe mortgage fraud will continue to grow, and despite comments earlier that it may decrease as the market decreases, we do not believe that to be the fact.

Victims of mortgage fraud—and we understand that the title of today's committee meeting is based upon the effect on lenders—is primarily on the borrower. Mortgage fraud affects all those who are involved directly and indirectly with the loan transaction. Borrowers, of course, in many instances are the primary victims. In many for-profit schemes, borrowers are duped into providing financial data, identity, or in many circumstances falsely advised as to the insignificance of fraud, and lenders are not affected so long as payments are made. We know that is not true. Lenders are affected significantly and sometimes resulting in closure of the business.

Our firm has represented over 100 small businesses or family-operated businesses employing tens of thousands of people who have been driven to the brink of business failure as a result of having to repurchase fraudulent loans.

We discussed earlier predatory lending versus mortgage fraud and whether or not it is one and the same. We believe predatory lending is a significant problem in the country and needs to be resolved. Mortgage fraud in its current industry context does not include predatory lending per se, but rather relates more specifically to the types of fraud perpetrated on lenders and borrowers alike.

Predatory lending legislation is intended to address the scam artists who rip off unsuspecting borrowers with abusively high-cost loans. In many instances, such loans fall into the subprime credit classification for no reason other than the interest rate associated with that loan. Notwithstanding the definitional confusion associated with predatory lending and the types of lending practices it is intended to prevent, mortgage fraud affects all loans alike, both prime and subprime, and borrowers alike regardless of their credit.

Can predatory lending practices be considered acts of mortgage fraud? Absolutely, but most statutes do not directly address, prevent or provide remedies for the types of fraud, such as flipping, occupancy, application and appraisal, that are the most prevalent.

Most lenders maintain rigorous standards for preventing fraud through automated detection systems, hands-on reverification of financial data, and rereviewing of property values. They pursue claims against all participants in the fraud, both criminal and civil.

Although we support recent actions by the FBI and the Department of Justice to promote the prosecution and deterrence of mortgage fraud perpetration, there is no better tool to prevent such actions than by hitting all of those contributing to the transaction where it hurts the most, in their wallets and in their pocketbooks.

Many of these fraudulent residential mortgage loan transactions, but for the participation of third parties such as appraisers and settlement agents, the fraud would never have succeeded. They are

the gatekeepers. However, as a result of current laws in various States, these particular parties are immune from liability.

In a typical fact pattern, the original appraisal is ordered by the mortgage broker. Upon completion of the appraisal, it is submitted to the lender by the mortgage broker, and submission of the appraisal report to the lender is standard. However, if, in fact, that appraiser has been negligent, grossly negligent, or fraudulently misrepresented the appraisal, the lender cannot bring their action in many States against that appraiser to recover. California and Texas and a few other States have adopted the Restatement 2nd of law in order to do so.

Finally, settlement agents. In many instances, settlement agents are acutely aware of when a flip transaction is about to occur. This is the result of their knowledge of contemporaneous transactions, coupled with their knowledge of a contract of sale indicating extraordinary increases. They are aware of sources of down payments, that the alleged borrower does not exist. Settlement agents are the linchpin to the fraud transaction. However, to date there are no flip statutes in the conventional lending industry firmly requiring the agent to disclose their knowledge or suspicion of the flip to the lender.

In conclusion, I hope members of the committee understand mortgage fraud is a serious problem in the economic lives of all Americans. Mortgage fraud is so devastating because it is so insidious. People often do not know when it has victimized them until it is too late. The fact is mortgage fraud carries a financial penalty that reverberates throughout our economy. We all end up paying the price for mortgage fraud one way or the other, either directly or through higher fees or insurance costs or other hidden taxes. Mortgage fraud is most assuredly not a victimless crime, and I support the actions of the committee that has recognized mortgage fraud for the dangerous blight that is, and hope that we do everything we can through legislation, enforcement and prevention to eradicate it.

On behalf of myself and The Prieston Group and the mortgage banking industry, I thank you for your time and attention.

Mr. NEY. Thank you.

[The prepared statement of Arthur J. Prieston can be found on page 79 in the appendix.]

Mr. NEY. Ms. Amiri.

STATEMENT OF BRIGITTE AMIRI, STAFF ATTORNEY, SOUTH BROOKLYN LEGAL SERVICES, BROOKLYN, NEW YORK

Ms. AMIRI. Mr. Chairman and members of the subcommittee, thank you very much providing me with an opportunity to testify today regarding mortgage fraud and predatory lending.

I am a staff attorney at South Brooklyn Legal Services, and I am a member of the National Association of Consumer Advocates. I represent low-income homeowners who have become the victim of predatory lending and have fallen into foreclosure or are on the verge of foreclosure.

We are inundated with hundreds of homeowners each year who seek our assistance because they are on the verge of losing their homes. We receive referrals from all over New York City, from

churches, communities groups, the courts, elected officials and government agencies. In recent years we have been overwhelmed with requests for assistance from families who have been the victims of property flipping. Most of these homeowners are young working families, often single mothers who are raising children alone, and are African American, Latino or West Indian.

Because property flipping has a devastating impact on low- to moderate-income, first-time home buyers and low-income communities throughout the country, it is these families and the communities in which they live that are the true victims of the mortgage fraud, which is the subject of the hearing today. I have had conversations with attorneys all over the country, and they have all told me the same thing: Property flipping is devastating to families and their neighborhoods from rural Oklahoma to urban areas such as Chicago. We must address this problem as a national problem.

The property flipping scams we see almost always involve a one-stop shop. They target first-time home buyers who are unsuspecting and promise them they will take care of all aspects of the home-buying process.

The scheme is enormously profitable. The business model is simple. We have discussed property flipping before, but basically the one-stop shop purchases the house cheaply, makes cosmetic repairs, works with a lender and appraiser to fraudulently overappraise the house, and then induces an inexperienced and unsophisticated home buyer to purchase the property. Families who have fallen prey to these companies will inevitably describe how much they trusted the salespeople who were employed by these one-stop shops, who repeatedly assured them they were in good hands, but at the same time were using high-pressure sales tactics. Families are often enticed by advertising slogans such as, "Why rent when you can own," because they have spent their entire lives living in rented apartments, and they seek the American dream of homeownership.

The fraudulent overappraisal is the key to the scheme. The flipped properties are often overappraised by tens of thousands, if not hundreds of thousands, of dollars by appraisers colluding with the one-stop shop and the originating lenders.

One-stop shops generally work with one or a few originating lenders that cooperate in the scheme, and the scheme is successful because the originating lenders are willing to make the loans based upon the bogus appraisals, but then turn around quickly and sell them into the secondary market.

The home-buying process is complicated, but the one-stop shop makes it sound easy by promising to take care of all of the details. By providing all of the real estate professionals for the transaction and by gaining the trust of the families, the one-stop shop completely isolates the families and prevents them from seeking outside assistance or help. The families are often kept in the dark because they often do not see the documents relating to the purchase and financing of the home until the actual closing. And at the closing table, they are pressured into signing these documents they do not understand. The attorney that is brought to the closing does not explain anything to them because the attorney actually works for the one-stop shop. Any protestations by the homeowner are usu-

ally met with assurances from the one-stop shop that they can afford the loan by the rental income, or threats that the buyer will lose her down payment if she walks away.

The monthly mortgage payments are often unaffordable because the properties do not produce the rental income and also because the lender or one-stop shop falsified income on the mortgage application to make the deal go through.

The property flipping cases that we saw several years ago when this scheme became prevalent exclusively involved loans that were insured by HUD's FHA program, and in these cases, the originating lenders and the lenders that purchased the loans on the secondary mortgage market did not risk financial loss because they were guaranteed a full return on the loan through the FHA insurance. Indeed, either the family would stay current, or they would default, and the house would be sold at foreclosure, and the lender would recoup all of its losses.

But my office recently started seeing a number of property flipping cases involving conventional mortgages where the originating lender worked in concert with the one-stop shop to inflate the value of the property, and then immediately sold the mortgage into the secondary market to obtain a full return, or even a premium, on the loan.

Most loans today are immediately sold into the secondary market. In the property flipping cases that we have seen, this means that the originating lender will not even hold onto the loan for even a day before it is sold into the secondary market and it escapes financial risk and sometimes liability.

If the secondary mortgage market, lenders and companies that buy these loans, conducted proper due diligence, spotted the red flags and refused to purchase these loans, the originating lenders would not have the ability to make these loans.

Just briefly I would like to tell you about Ms. W, who represents the type of clients we represent. She is African American, 68 years old, a retired school aide living on Social Security. She sought to purchase her first home after being priced out of her long-term apartment. After seeing an advertisement for a one-stop shop, she made an appointment to look at homes. She gave the one-stop shop $20,000, her entire lifesavings, as a down payment. What she did not know was the property she was purchasing had been flipped. It had been bought by the one-stop shop only 3 months previously and marked up $169,000. She was also unaware that it was intentionally and fraudulently overappraised by almost $150,000. She also did not know that the attorney that the one-stop shop arranged to represent her actually worked for the one-stop shop. When she showed signs of wanting to back out of the deal, they threatened to keep her down payment.

The loans were unaffordable. The mortgage payments far exceeded her income, and when she moved in, she started to realize the problems with the transaction. One thing that she realized was that the property was not a legal two-family, which meant that the rental unit upstairs was illegal, and she could not collect the rent income.

I would like to jump to some of the suggestions that we would like to make to try to prevent these types of schemes from occurring.

First, for FHA-insured loans, HUD should commission an independent appraisal, appraisal review, or some sort of quality control before the loan is made. I understand this will take a lot of resources, but even if it started by focusing on the hot zones that HUD has already designated as predatory lending areas, that would be a good start.

Second, HUD should extend the current antiflipping regulations, which currently prohibit FHA insurance for homes bought and sold within 90 days, to prohibit insurance for homes bought and sold within 6 months.

Third, in 2003 HUD proposed and passed a regulation that would hold originating lenders liable and accountable for appraisals, but they should go one step further with that as well.

Fourth, lenders and companies that purchase conventional and FHA-insured loans should conduct appraisal reviews and search for red flags prior to purchasing the loans. They should keep track of the lenders that make bad loans, underperforming loans, and illegal loans, and stop purchasing them from those companies.

Thank you again for this opportunity and your invitation to provide testimony today.

Mr. NEY. Thank you.

[The prepared statement of Brigitte Amiri can be found on page 49 in the appendix.]

Mr. NEY. Ms. Trujillo.

STATEMENT OF ECIMA TRUJILLO, NATIONAL FIELD DIRECTOR, ACORN HOUSING CORPORATION, LOS ANGELES, CALIFORNIA

Ms. TRUJILLO. Chairman Ney, Congresswoman Waters, and members of both subcommittees, thank you for the opportunity to address you on the important issue of mortgage fraud. My name is Lez Trujillo, and I am the national field director of the ACORN Housing Corporation.

ACORN Housing builds and rehabilitates homes, and it is one of the largest providers of housing counseling services in the country. ACORN Housing works closely with our sister organization, ACORN, the Association of Community Organizations for Reform Now.

Mortgage fraud is a national problem. In recent weeks much of the attention has been about how lenders are hurt by this form of fraud, but it is more important to look at the people who have been taken advantage of all over the country. While it hurts the bottom line of financial institutions when they are taken advantage of, it devastates the lives of citizens when they are victimized by these scams.

Let me begin by describing a case in Baltimore. In 1998, Matilda Watson, a participant in the welfare-to-work program, bought a house with American Skycorp. The loan officer falsified information on her application to get the loan approved, including nonexistent child support payments. Matilda thought $54,000 sounded high for the house in that neighborhood, but her realtor insisted that an

FHA lender would not approve a loan if the house was not worth it. When she later asked about home inspection, she was assured the lender would make sure the house was in good shape.

As soon as Matilda closed on the loan, she found out the house was falling apart. The furnace stopped working, the upstairs plumbing leaked into the kitchen, and the lighting was faulty.

Most tragically for Matilda and her family, the Department of Social Services deemed the house unfit for her children to live in, and they removed her children from the home. American Skycorp abused the FHA program to obtain loans on homes with inflated values and amid promises of future repairs.

African-Americans received 77 percent of the company's loans. The Maryland Attorney General's Office noted, where the consumers default, and the property is foreclosed upon, the practice hurts the neighborhood in which the consumer lives.

When ACORN brought these problems to light, they were sued by $10 million by Skycorp for defamation of character. The suit was quietly dropped when the Federal Government successfully prosecuted the company for the same practices ACORN had accused them of.

Another scam we have come across is the purchase of contract for deed, which has been called nothing less than modern-day share shopping. Houston ACORN discovered that the developer, Jack Markman and his associates, have targeted up to 800 families in the city in this scam. All of the home buyers we talked to monolingual Spanish-speaking immigrants, and they signed contracts in English, which they did not understand.

The main problem with the contract is that residents would have to wait 20 to 30 years before they could become owners of the house. In many cases, there are no legal descriptions or maps with the contract. Most of these loans have high interest rates and unjustified tax and insurance payments.

The insurance appears to have a $5,000 deductible. The insurance company offices are based out of the Turks and Caicos Islands, and they do not have a license to operate in Texas. One home buyer's house burned down not long ago, and she was never able to get money from the policy. After intimidating families to move out, Markman has sold these houses time and time again, making large profits each time.

Since early 2003, over 140 families have joined ACORN in taking a variety of options to address their concerns. The home buyers want marketable title to their homes, and to ask for local and State protection. There is an incentive to be reckless in a market driven by value and securitization—because too many participants from lenders to brokers to appraisers make money up front—and there is an incentive to take action to harm borrowers. This is especially apparent in the super hot market where business is done with lawyers and all the protections.

Because so much money is made up front in the form of points and fees, and in the form of yields and premiums to brokers, there is less reason to insure that the loans perform, there is also less access to legal resource because of the prevalence of mandatory arbitration costs.

Unfortunately, it is not just fly-by-night operators who have been involved in these scams. Even a larger lender like Wells Fargo was recently accused of pressuring appraisers to justify large loans. We have found that this practice has targeted the most-vulnerable consumers, including low income people, the elderly, and immigrants. These vulnerable home buyers are more likely to be in the subprime market, and are in effect, punished twice. They pay more for the risk, and then if things go wrong, they face the consequences.

We need both national protections against predatory practices in a State and local action. The States need to be able to respond quickly to the problem. Federal action cannot preempt their ability to protect their citizens. This is why we oppose the OCC's preemption of the State laws. We also need housing counseling to insure that borrowers can spot bad lenders, and that borrowers are connected with reputable market participants.

Finally, we need a strong community investment act that provides incentives for responsible financial institutions to lend under server communities and lower ratings for those that participate in predatory practices. The FDIC should not weaken this law.

Mortgage fraud is a complicated and troubling issue. While it causes heartache for banks and other lenders as they look at their bottom line, it causes far worse anguish for many of the families we represent. Their experiences must be a part of the debate on how to end mortgage fraud.

Thank you for the opportunity to address you today. I am happy to answer any questions you may have.

Chairman NEY. Thank you very much.

[The prepared statement of Ecima Trujillo can be found on page 102 in the appendix.]

Chairman NEY. I wanted to ask Ms. Amiri about the One Stop. If you don't have—I understand about problems maybe with One Stop and who is running it. If you don't have the One Stop, how do you get guidance or counseling to people if you don't have a One Stop?

Ms. AMIRI. How would you give guidance and counseling to a first-time home buyer?

Chairman NEY. Yes.

Ms. AMIRI. When we do first-time home buying training sessions as well, we tell them what to look out for—always to get their own attorney, get their own building inspection and get a sense of the conditions of the property prior to——

Chairman NEY. But you provide legal services, don't you?

Ms. AMIRI. We do. We do.

Chairman NEY. You provide them free?

Ms. AMIRI. To low income and moderate homeowners. But we also train other community advocates. We speak to first-time home buying counseling sessions to warn people about what not to get into—because obviously it is easier if they don't get into a bad loan in the first place rather than come to us after they have already gotten into it.

So we would warn them in lots of different ways about how not to get into a bad loan as a first-time home buyer.

Chairman NEY. Thank you.

Mr. Matthews, would a national registry work best if it covered all loan originators, who would be—if we had a national registry, who would be in that?

Mr. MATTHEWS. I think that one of the issues today is that there is not as much accountability in the mortgage industry as there should be. And if you look at the history of the industry, it has gone from this—a very personalized industry affiliated with saving and loan companies to a much more depersonalized industry with mortgage brokers.

I think the answer to your question is that it would definitely be appropriate for loan originators—whether it be a broker or retail loan officer to be in a national registry. And that way you can track not only the company's performance, but the individual's performance as he or she goes from company to company, or migrates from State to State.

Chairman NEY. Because I knew there was a case, I was on a roundtable one time where somebody had done something—just moved to another State. I think, you know, if you look at the overall picture, I have had a lot of mortgage brokers and bankers come to us and say—and they did in the State of Ohio when I was in the legislature and say we want to tighten this up—you know, we want to take the fraudulent side out of it—you know, police their own type of situation, which I think has been good—because the vast majority of them are decent people.

But there has got the to be a way to find the ones that aren't and not have them escape State to State. And that is maybe why I thought a national registry—pretty comprehensive it would have to be though. You can't just have that group in or that group in—and I think you have to have that pretty comprehensive, I would assume.

Mr. MATTHEWS. Absolutely. Just recently, Ohio passed laws to expand the regulation to loan originators. And if you look at the securities industry, what they went through in the 1970s, the State security agencies banded together to create a central repository to track the registration and performance of stockbrokers, and so that would be something that I think would be appropriate for the mortgage industry as well.

Chairman NEY. Whoever would like to answer this. On the first panel, I asked if it made a difference whether the volume of loans, the originations, decreased as it relates to a corresponding decrease in mortgage fraud cases. In other words, does this only go up exponentially when the loan volume increases, the fraud increases, or can you have a loan volume decrease and the fraud still continues steady? If anybody would——

Mr. MATTHEWS. I think there are some countercyclical aspects of the mortgage industry. As loan volumes decrease, mortgage fraud will not necessarily correspondingly decrease. A lot of times it will increase. And part of the problem is that the industry is commission-based.

So if I am in a boom time with significant refinances because of low interest rates, I am making a significant income as a loan broker or a loan originator. As rates rise, and my ability to originate loans goes down, my income will go down as well. Con-

sequently, loan originations will often push through problem loans in a slow market in order to get a commission.

Chairman NEY. The last question I have if anybody wants to answer. Each one of you, I think, has touched upon or mentioned appraisals in the system are, or at least a few of you have. Wouldn't it behoove a loan originator to have some type of random check on appraisals, to have, you know——

Ms. MCCALL. I would like to address that.

Chairman NEY.—idea for my colleagues. I better mention that, but we were talking about it. Wouldn't a random check be good?

Ms. MCCALL. Yes.

Chairman NEY. To make sure your appraisers are giving you the right info.

Ms. MCCALL. You are exactly right. We do that. There are several things that we do. First of all, many lenders will approve appraisers.

Chairman NEY. Does the industry as a whole do it?

Ms. MCCALL. As an industry as a whole, you will either approve appraisers or you will use a list of excluded appraisers. There are a couple of lists out there that are readily available. Unfortunately they are not comprehensive, such as the Freddie Mac list or the FHA debarred list.

Chairman NEY. But beyond that—because I went one time, and they said here is a list, and I said I definitely don't want that guy, because I knew him, and I definitely didn't want him, but he was on the list.

Ms. MCCALL. So there are a couple of other things.

Chairman NEY. But I am saying, even if they are on the list, do you go out and—okay, here is your approved list. I know you have got that. But do you ever go out and double-check an appraisal randomly?

Like here is Susie Smith on the approved list to be an appraiser. She says this house is worth this. Is that ever randomly checked?

Ms. MCCALL. Yes, it is both done randomly, and it is done on an adverse basis. We do it pre-funding and post-funding. There are QC requirements that necessitate lenders—all lenders—to necessitate QC which includes a component of verifying on your 10 percent sample or statistical sample actually go out and randomly choose appraisals to reverify.

We also do it in the pre-funding basis in two areas, one when the underwriter actually gets the transaction and looks at the appraisal. Many of the underwriters have received training to look at the appraisals and question the right things. And in those cases, we can use several tools. There are automated tools. We can send appraisers out to the property to inspect to tell us, yes, we really do think that value is good. And then the third kind of thing that we would do on a prefunding basis would also be—from a prefunding QC perspective—which is not typically part of the origination process, but does occur before the loan funds. Obviously that protects us, and it protects the consumer from buying a home that is overvalued.

Chairman NEY. Thank you.

The gentlelady from California.

Ms. WATERS. Mr. Chairman, I would like to thank all of our panelists for participating today and a special thanks to Ms. Trujillo with ACORN all the way from California, and of course legal services, and those of you who are working really in the vineyards with all of the problems that our consumers have and particularly our low-income seniors.

You know, I just went through one of these home-buying experiences. It is very difficult, I am sure, for many of our low income and middle class working people to negotiate their way through the purchase of a home, and nobody is helping them.

First of all, I was surprised that someone would put a stack of papers in front of me and say just sign. Nobody explains what they are. Nobody explains the fees. You have to ask one by one, what is this fee, what is this for. And then you discover there is something called a county transfer fee. And you call the county, and they say, we don't have anything to do with that. And then if you are lucky, you know, they say, well, we will take it off.

Then I discover that, you know, the real estate people, brokers times, the mortgage—well, the real estate salespeople are sometimes getting kickbacks on everything. Kickback on the hazard insurance policy. You know, people are pushing you, get it from this one, get it from that one. Well, what is all of this about? People are getting a commission, they call it. I call it a kickback. They get a commission on the hazard insurance—and, guess what, the appraisals are being marked up. And, guess what, the real estate salespeople and others are getting a commission on the appraisals. I want to know, why is an appraisal for this place 1,500 by this person, another person told me they can give it for 750 and another lender says, oh, we will give it to you for free.

So, I guess what I am saying is, while we are talking about fraud, and we are talking about the harm to the lender, and we are trying to talk about harm to the consumer, that is not everybody in this business, I want to tell you.

The first harm, I am going to tell you, is that most people don't know what they are doing and they can't negotiate a purchase because it has gotten really implicated and nobody really explains. Even if you do sometimes a first-time home buyer course, and you try and cover everything that they will encounter—first of all, many times, they are not talking to anybody face to face. You know they don't like to talk to you face to face any more.

What they like to do is you called the lender, and they put you on the telephone to an underwriter or somebody, and they fax or e-mail you some papers, and they tell you to sign them and send them back and you fax and sign and send them back, and fax and sign and send back, and here is this first-time home buyer or somebody by themselves trying to do all of this.

I guess there is no requirement in law that the buyer must be walked through the contract, every aspect of it, step by step, and there is no requirement of that in law. I am telling you, nobody offers you anything. So despite the fact we are talking about fraud to the lender and fraud—this whole industry needs a real review, Mr. Chairman, a real review. And the average consumer needs a way by which to have someone review a contract before they enter into it and sign it, because there are so many decisions to be made.

You have—I wish everybody could negotiate their interest rates, I mean, but it goes, everything now from 4.7 to 7. And don't tell me it is on a different kind of loan, fixed-rate mortgage, 30 years. I mean the interest rates, you know, differences are this wide. I don't know how people know that they can negotiate it or, you know, what to ask for it, but this is a very difficult business now. It is very complicated and people are left alone to fend for themselves. I am not so worried about the lender, I mean, as I am the consumer in all of this.

Lenders may get ripped off, but they have got enough money and enough lawyers and enough expertise to protect themselves and to go into court and to do a lot of things. But the poor consumers don't have much of anything. I appreciate whatever it is the government is doing for lenders and for consumers, but it is not enough for the consumer, I tell you. It is just not enough.

And, again, I don't know how—you indicated that you advised people to go out and get a lawyer. Well, that adds to the cost. I mean, most working people and poor people just can't pay lawyers fees, you know, I don't know what lawyers charge to be involved. I think here in Washington D.C., you are required to have a lawyer, but in most places you are not.

So, while we are looking at this, and this is good that it raises a subject. I think, Mr. Chairman, that one of the things we might want to consider is a complete review of the home buying mortgage process and figure out how we can eliminate some of the confusion, the obstacles, and require, you know, more information to the consumers at the time of the signing of the contract, that people don't just get thrown a bunch of papers that they have to sign and told to walk through them, each line by line.

I guess, and let me just say, it may be a good idea to have a database. But, Mr. Matthews, did your company have a database in Florida?

Mr. MATTHEWS. A database in——

Ms. WATERS. A database in Florida for felons who were——

Mr. MATTHEWS. We do have a database, it is nationwide. It includes derogatory data such as sanctions taken by regulators.

Ms. WATERS. No, this is on a different subject now. Aren't you the guys who developed the database for the identification of felons in Florida who were supposedly prevented from voting because the law does not allow them to vote? Was it your company? ChoicePoint? Was it ChoicePoint?

Mr. MATTHEWS. I am with Mortgage Asset Research Institute. We are a subsidiary of ChoicePoint. I am not familiar with the database that you are talking about. I am not sure if ChoicePoint developed that or not. That is not in my field of expertise.

Ms. WATERS. Well, you better check your parent company, because I think your parent company developed a bad database, and that database was racked with problems and inconsistencies and names, I am not blaming you for it, but if CheckPoint is your parent company, maybe you ought to know what that is all about. So that when somebody hears that name, you know, the ears go up and they think, oh, no, we don't want you to develop a database. Check it out and see what they can tell you about that.

Mr. MATTHEWS. I will follow up on that. Thank you.

Ms. WATERS. Yes. Thank you.

That is all, Mr. Chairman.

I yield back.

Chairman NEY. Thank you.

The gentlelady from California.

Ms. LEE. Thank you, Mr. Chairman, I want to thank you and the ranking member for this very important hearing today. I was in a markup, so forgive me if what I ask is redundant.

First, let me just say it seems like the more we support and push for the American dream to become real for ordinary Americans, the more scams we are faced with by legitimate professionals. It seems like the more—we want to include more people in homeownership, an opportunity is grabbed by the pros the figure out how to scam them. And I have got to say that, because I have many, many constituents who continue to go through this.

Today, I just have a couple of questions on—I am trying to get a handle on the definitions between flipping, speculation and chunking. I mean, what—what are the lines drawn and what is the difference between flipping and speculation and then speculation and chunking, or are all of those definitions kind of—connote the same practice? Who can answer that? I am not sure who to direct the question to.

Mr. PRIESTON. Thanks, I will take it, it looks like——

Ms. LEE. Okay.

Mr. PRIESTON.—by default. Primarily the issue of flipping, I think is the one—the speculation is not so much a mortgage-fraud related term as a general term as it relates to real estate and properties, misleading the actual, you know, appraised value, inflating values on the sale of raw land as well as land to be developed. It could very well be that this is a fixer-upper, and with a good appraisal that relates to an increased value of the property if certain amounts of money were put into it. You could speculate on that property—and essentially with that fraudulent appraisal, recoup benefits in a fraudulent manner. That is essentially speculation.

The flipping, however, is a little bit more complex. It relates to the idea where you purchase a property, many times these are HUD properties that require levels of renovation. You purchase a property, I would say a value of $15,000. You then sell that property for $150,000. And the way to do that is essentially to have dual escrows. You have to have an inflated appraisal. You have to have a duped borrower or, in fact, a straw borrower on the other side of the transaction, that the properties are bought and sold simultaneously, and the lenders are unaware this is happening because recordings only go back so far and it takes a bit of time before these multiple transactions actually hit. And then as a result, a gain of $135,000 is made instantaneously.

And in my presentation of my testimony, one of the issues I brought up was the fact that a settlement agent is a gatekeeper. It is a gatekeeper in that they are privy to all the transactions that are going on. Yet, they do not have liability, unless of course they are guilty of some level of malfeasance. They don't have a liability to communicate what is happening in front of everybody else's eyes in that room.

Ms. LEE. So flipping does not have criminal penalties at this time.

Mr. PRIESTON. It can. It can have criminal penalties. It does give rise to criminal penalties in certain circumstances. And some agents—as Agent Swecker said earlier today—and some of the larger scams—and some of the larger scams such as in Brooklyn, there have been criminal penalties imposed upon settlement agents.

But in the—let us say—less sexier claims where you have, say, $2 or $3 million in losses with 30 borrowers involved, the settlement acts have gone free. And the lenders who have the resources to act on behalf of the borrower and on behalf of themselves can't necessarily prosecute that settlement agent in varying States throughout our country. Because, again, there isn't that duty that arises.

Chunking basically comes from this idea that you can, you know, churn a loan in and out. Brokers like to take their commissions rather quickly. They can move a person, a property rather quickly. They can make a loan, and then 60 to 90 days later, put them in another loan. And they take a piece along the way - and it is kind of moving them from one property to the next rather quickly, thinking that now they have taken advantage of yet another or more beneficial rate—lying to that borrower, misrepresenting to that borrower—that, in fact, it is a more beneficial program when it is not——

Ms. LEE. Are there criminal penalties?

Mr. PRIESTON. And under the statues that this committee has helped promulgate under a rather confusing web of criminal penalties such as mail fraud and wire fraud and false instruments, yes. But, again, we are here to talk about maybe kind of cleaning that up little bit.

Ms. LEE. Sure. Let me ask Ms. Amiri, with regard to the inflated appraisals and independent appraisal review. Are there—I mean, there are no national standards now. What do States have or do we have that is just a minimal kind of requirement for appraisers, because it sounds like there are none. It is kind of a free-for-all.

Ms. AMIRI. Well, I can talk about individually with New York. The New York Department of State oversees appraisers and sets certain guidelines for their professional licensing. There is also a national organization, USPAP, which I can't remember the name, what the acronym stands for, but they also set best standards, best guidelines, best practices for appraisers on a nationwide basis.

And in New York, for example, the guidelines of this appraiser association have set on a national basis—have just been codified into our State regulations. So there are—the New York State Department of State should be the ones who would be going after these appraisers and disciplining them.

So, I only am aware of what is going on in New York, and I can't talk about it nationally.

Mr. PRIESTON. Just to add to that, again, there is no better way to put a stop to deterrence and deterrence on a civil level where we can act fast and move quickly with a great deal more resources. If we have the legislation in place, we can act on behalf of the

State as well as on behalf of the borrowers. Again, we do have those issues relative to——

Ms. LEE. So would this be State legislation or national?

Mr. PRIESTON. Well, it is a national issue as well as State level. It depends upon the type of transaction. You have FHA-type loans, which, of course, you have Federal preemption involved—but then, of course, you have State level, case law. And there was case law in New York which created a necessity for privity of relationship between the appraiser and the lender. Otherwise, the lender can't sue the appraiser.

Ms. MCCALL. I did have one other comment on that. And talking about the different State laws, what happens is there is this kind of national requirement for all appraisers in preparing appraisers. They need to construct them in a certain way. They need to make certain representations. And so that is very standard nationwide.

However, State to State, the rules for becoming an appraiser, the experience that is required, the number of the bond—whether you need one or not—is different from State to State. And so it does make it difficult as a national lender to understand exactly what the experience level of your appraiser is. There are also different and varying degrees appraiser levels.

Ms. LEE. Yes, I have wondered. In California, for example—and I am from Oakland, the Bay area. I see—and I have often wondered if part of the high cost of housing and the median cost of the house—of course, in my district is now, what, $500,000. Could that be part of that be because of these inflated appraisals? I mean, after 6 months, another appraisal. I mean, I have seen houses go from 200,000 to 350 in 6 months from 350 to 500, and then all the other houses in that area go to 550 then in 6 months there, is one sold for 600. You know, so I know the appraisal process is part of this totally outrageous, the lack of affordable housing.

Mr. PRIESTON. I am from the Bay area as well.

Ms. LEE. See——

Mr. PRIESTON. I can totally relate to what you are talking about. And the affordability issues of housing and how volatile that market is slowly becoming because of those extraordinary increases in value. We saw that during the dot.com era on the peninsula.

The good news is the Bay area is one of the low areas as it relates to fraud and mortgage fraud. There is a good reason for that. It is because in the Bay area you have something called title companies that you have to go to—and you don't have settlement agents that are separate and distinct—or closing attorneys that are separate and distinct—that is why you don't have flipping occurring there.

It is a very important distinction. When we go into those title insurance companies, guess what, the title insurance company is going to be liable if in the event there is a flip that is going to occur. So you don't see those transactions there. And that is why, comparatively speaking on the indexes and in our company where we receive claims around the country, it is the lowest area.

Ms. LEE. But you see speculation though, you see the houses purchased for 200,000 and in 3 months they go on the market for 500,000.

Mr. PRIESTON. That may be something more due to an overheated market as opposed to fraud.

Ms. AMIRI. If I could add to that what we are seeing in Brooklyn is actually what you described in certain neighborhoods. The one-stop shops are now—have a large market share. And so what they are doing is they are using their sales to legitimize these astronomical prices in neighborhoods in Brooklyn that you would never imagine houses would be going for. So if you look at an appraisal from one of these one-stop shops, they are using comparable sales as a measurement of what they are going to sell your house for.

Ms. LEE. And appraisals are so key though in developing the comparable sale criteria?

Ms. AMIRI. Right.

Mr. PRIESTON. You are absolutely right. I mean, let us move the Bay area out of the question and bring it back to Brooklyn, where we all know about the sensitivities and the pain that many, many homeowners have undergone and borrowers that never should have owned four- to six-unit buildings in that area.

Let us keep in mind that what Ms. Amiri said just now is exactly right. That what is happening is one is begetting the other. They start out with one fraudulent appraisal, and now you have 10. Now you have 10. And what they do is they keep the payments going for enough time so the loan remains current and alive, and therefore the value of the property stays consistent.

Once you have one or two condominium complexes in Houston, hundreds of those just like that, for that very reason, in that same manner, you get two or three, you use the same $30,000 as a payment, you get an appraisal, you get one or get two, now, you get legitimate appraisers while looking at those comps and seeing that those are legitimate transactions.

Now, it has been simply masked completely and almost undetectable if it goes on long enough. And the key here is letting it go on long enough. If those payments are made month after month with the proceeds of the first loans, then you can mask it for a year. And now you are beyond those early payment default detection programs that the industry knows about and can spot right away. And the whole thing implodes from about 18 months to 2 years from the original funding dates.

Ms. TRUJILLO. I also have something to add to that. What we see is that appraisals—and some of these older value appraisals are shifting a little bit, not only from mortgage brokers, but also to prime lenders, to regular lenders. And that appraisers are forced to meet the number. I mean, we, I, have worked in Oakland for 7 years before moving to L.A., and every single appraisal meets the price, especially for the purchase.

Now, the only thing that we see is loan flipping, where appraisals meet the new price of the house, essentially high-priced areas, where families are refinanced four to five times within the same year. Magically, the appraised value always keeps increasing at a crazy rate.

Ms. LEE. Yes.

Ms. TRUJILLO. It is something that we are looking at in general. Many of these cases involve fair housing violations, because they targeted specific demographics. And that is how we have been able

to catch most of the actors and, also, you know, luckily, if a lender breaks any hope or risk of violation, that is also where we can get, dissect the whole case and figure out what happened. It is very regular, or, you know, normal now for appraisals to always meet the price.

Ms. LEE. Thank you.

Thank you very much, Mr. Chairman. I mean, this is mind boggling because as we try to make sure that the American dream is real for everyone in America, what—what we are seeing is that people are getting messed over, and their lives are being shattered. And the institutions that are supposed to support them really aren't. And, I mean, I hope we do have a further hearing on this, because somehow we have got to get a hand on this. Because otherwise no one will be able to buy a home in America.

Thank you very much.

Chairman NEY. Thank you. I want to thank the witnesses and members for being here today.

Also without objection, there is a statement that Fannie Mae wants to put in the record, hearing no objection.

[The following information can be found on page 126 in the appendix.]

Chairman NEY. Also I would, without objection, the staff will be able to make conforming or technical changes to the language, and also some members may have additional questions for the panel. They may want to submit them in writing. Without objection, we will keep the hearing open for 30 days for members to submit and receive answers.

I want to thank you again for your patience.

Thank you very much.

[Whereupon, at 1:12 p.m., the subcommittee was adjourned.]

A P P E N D I X

October 7, 2004

Opening Statement

Chairman Bob Ney
Subcommittee on Housing and Community Opportunity Hearing

Hearing on
"Mortgage Fraud and its Impact on Mortgage Lenders"

Thursday, October 7, 2004

Today the Housing Subcommittee meets to discuss mortgage fraud and its affect on mortgage lenders.

This Subcommittee, along with Chairman Bachus's Financial Institutions Subcommittee, conducted a number of hearings concerning abusive lending practices, sub prime lending, and how to ensure credit availability for those who need and want it. During these previous hearings, topics revolved around addressing fraudulent schemes and how it affects the individual consumer.

However, consumers are not the only ones affected by abusive lending practices. Financial institutions and other lenders are also victims of mortgage fraud and lose millions each year through this type of corruption. Some studies have shown that between 10 and 15 percent of all home loan applications include some fraud or misrepresentation. Lenders can choose to absorb the loss and reduce earnings that harm stockholders or charge higher consumer fees to recuperate losses. Government-insured loans that fall victim to fraud end up being paid by taxpayers. Examples of this fraudulent behavior include elaborate flipping schemes, straw buyers, fake credit histories, inflated appraisals, fabricated pay stubs, and falsified tax records.

One of today's witnesses, the Federal Bureau of Investigation, has stated that mortgage fraud has the potential to become a national epidemic that could expose lenders to hundreds of millions of dollars in losses. As a result, the Bureau has targeted a variety of fraud schemes through its "Operation Continued Action," the largest nationwide operation in FBI history directed at organized groups and individuals engaged in mortgage fraud.

From its inception in August 2004 through this month, Operation Continued Action investigators have identified more than 245 subjects in 158 investigations in 37 states. More than 151 indictments have been filed to date. These charges have thus far led to more than 144 arrests, convictions, sentences, and millions of dollar in forfeiture and restitution.

The United States mortgage market is the deepest and most affordable in the world. Due to the evolution of unique funding structures for mortgages, Americans pay less for mortgages than almost any other country. As a result, this country has the world's highest homeownership rate. Today's hearing is another important step

as we attempt to find common ground with comprehensive solutions to the problem of abusive lending.

Our witnesses have a variety of expertise in the issue of mortgage fraud and I look forward to hearing their testimony.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Housing and Community Opportunity
"Mortgage Fraud and Its Impact on Mortgage Lenders"
October 7, 2004

Good morning Chairman Ney, Ranking Member Waters, Members of the committee and witnesses.

I could not help but notice that there are several organizations present that have led this fight for years on the behalf of the consumers. I applaud the efforts of all of you. I especially want to recognize ACORN as they are such a wonderful working force in Missouri and, of course, in St. Louis.

I am pleased that we are addressing all facets of the mortgage arena when as we employ various techniques to fight fraud and abuse. Consumers, the lending industry and the markets all suffer when fraudulent schemes and activities are employed by assorted financial predators. We must continue to address these issues in these areas in order to preserve a healthy system that is getting better.

I am particularly interested in hearing more about "Operation Continued Action", the nationwide investigation conducted by the FBI. I have been aware of the huge amounts of money that is defrauded in mortgage finance; however, I am stunned by the organization of large scale operations that engage in financial institution fraud.

Mr. Chairman, I ask unanimous consent to submit my remarks for inclusion in the record?

Thank you.

Testimony

Before

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

of the

COMMITTEE ON FINANCIAL SERVICES

Regarding

"*Mortgage Fraud and its Impact on Mortgage Lenders*"

October 7, 2004

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Mr. Chairman and Members of the Committee, thank you very much for providing me with an opportunity to testify today regarding mortgage fraud and predatory lending. I am a Staff Attorney at South Brooklyn Legal Services in the Foreclosure Prevention Project and I am a member of the National Association of Consumer Advocates. The Foreclosure Prevention Project ("Project") is an integrated outreach, education, and legal services delivery program for low- and moderate-income homeowners at risk of foreclosure, with a special focus on predatory lending practices by subprime mortgage companies. Our Project is the first and only of its kind in New York City, and we are inundated by the hundreds of homeowners every year who seek our assistance because they are on the verge of losing their homes. We receive referrals from all over New York City, from churches, community groups, the courts, elected officials, and government agencies.

At SBLS, we receive hundreds of requests each year from families who need legal assistance. At minimum, we provide investigation and advice to everyone who contacts our office. In recent years, we have been overwhelmed with requests for assistance from families who have been the victims of a predatory lending scheme called property flipping. Most of these homeowners are young working families, often single mothers who are raising their children alone, and are African-American, Latino, or West Indian. Because property flipping has a devastating impact on low and moderate-income first-time homebuyers, and low-income communities throughout the country, it is these families, and the communities in which they live, that are the true victims of the mortgage fraud that is the subject of this hearing. I've had conversations with attorneys all over the country – from rural areas in Oklahoma, to urban areas such as Chicago – and they have told me that property flipping is seriously affecting families and the communities in their area as well; accordingly, we must address this issue as a national problem.

Property flipping scams almost always involve a "one-stop shop" that targets first-time homebuyers and convinces them that they will take care of all aspects of the home-buying process, including arranging for financing and providing closing attorneys. The scheme is enormously profitable. The business model of the one-stop shops is simple: they purchase houses cheaply,[1] make cosmetic repairs, work with a lender and appraiser to fraudulently overappraise the house, and then induce an inexperienced and unsophisticated homebuyer to purchase the property. The flipped properties are often bought by the one-stop shop and then re-sold within a short period of time, often less than three months. Families who have fallen prey to these companies will inevitably describe how much they trusted the sales people employed by the one-stop shops who repeatedly assured them that they were in good hands, while at the same time engaging in high pressure sales tactics. The families are often enticed by the one-stop shop's heavy advertising, with slogans such as "Why Rent When You Can Own?" because they have spent their entire lives living in rented apartments, and they seek the American dream of homeownership.

[1] Many of the properties are purchased at foreclosure sales or at a deep discount from desperate homeowners in foreclosure.

The over-appraisal is the key to the scheme. The flipped properties are often over-appraised by tens of thousands - and in some cases by hundreds of thousands - of dollars by appraisers colluding with the one-stop shop and with the originating lenders. One-stop shops generally work with one or a few originating lenders that cooperate in the scheme. The scheme is successful because the originating lenders are willing to make loans based on the bogus appraisals, loans which they quickly turn around and sell into the secondary market.

The homebuying process is complicated and intimidating, even to the most sophisticated and well educated. The one-stop shop makes the process sound easy by promising to take care all of the details. By providing all of the real estate professionals for the transaction, and by gaining the trust of the families, the one-stop shop completely isolates the families and prevents them from seeking any outside advice or assistance. The one-stop shops discourage inspections, and provide the families with an attorney who typically works in tandem with the one-stop shop to lead them to believe that they are adequately represented.

The families are also kept in the dark because, in most cases, they do not see any of the documents relating to the purchase and financing of the home until the closing. Some of our clients were unaware of the sale price of the home until the closing, but agreed to purchase the house based on assurances that the monthly payments would be affordable. By the time they reach the closing table, the homebuyers are pressured into signing documents they've never seen before, and don't understand. Of course, clarification is not provided by the attorney brought to the closing by the one-stop shop. Any protestations by the homebuyer are usually met with assurances from the one-stop shop that the mortgage will be affordable with the rental income, or by threats that the buyer will lose her downpayment if she doesn't go through with the transaction.

The monthly mortgage payments are often completely unaffordable because the properties do not produce promised rental income, and because the one-stop shop and/or lender falsified income on the mortgage application to make the deal go through at the inflated value. Many of the homes that are sold by one-stop shops are in poor condition. The families are usually promised that the home will be fixed up nicely; however, when the buyer moves into the property, she often finds that the promises were hollow, and that the property needs substantial repairs. Often the families are unable to pay for the needed repairs while at the same time making the monthly mortgage payments. Many targeted families fall into default and eventually face losing their house at foreclosure.

At SBLS, the property flipping cases that we saw several years ago, when this scheme became prevalent, exclusively involved loans that were insured by the United States Housing and Urban Development's Federal Housing Administration (FHA) program. In these cases, the originating lenders, and the lenders that purchase the loans on the secondary mortgage market, do not risk any financial loss because they are guaranteed a full return on the loan through the FHA insurance. Indeed, either the family will stay current or, if the family defaults and the house were sold at foreclosure, the lender would recoup all of its losses through a claim to the FHA insurance.

My office has recently started seeing a number of property flipping cases involving conventional mortgages, where the originating lender worked in concert with the one-stop shop to inflate the value of the property, and then immediately sold the mortgage into the secondary mortgage market to obtain a full return, or even a premium, on the loan. A lender that makes a conventional loan, and then holds it in its portfolio throughout the life of loan, is unlikely to fraudulently overappraise the property since the value of the collateral obviously should not exceed the loan amount. In general, mortgage lending has changed dramatically in recent years, and as a result, many originating lenders sell the mortgage even before they service the first payment. Most loans today are immediately sold into the secondary market. Because the loans in the property flipping cases are immediately sold, the originating lender simply pawns off these loans and escapes financial risk. The companies who buy these loans provide the capital to the originating lenders to continue the cycle of abusive lending. If the secondary mortgage market – lenders and companies that buy these loans - conducted proper due diligence, spotted the red flags, and refused to purchase these loans, the originating lenders would not have the ability to continue to make these loans.

These property flipping schemes wreak havoc on families who may have only one chance in their lifetimes of owning a home. A family who defaults and loses their house at foreclosure may lose their life savings that was used for the downpayment, their credit will be ruined by the foreclosure action, and if the foreclosure auction doesn't yield a bid that is high enough to cover the outstanding mortgage amount, the family will be liable for any deficiency, and the lender can sue her for that amount.

These schemes also have a devastating impact on entire communities. In some areas, homes that have been foreclosed on remain vacant and abandoned, which affects the overall property values, crime rates, and business opportunities in that area.[2] In New York City, the one-stop shops create a false housing market by relying on values of homes of properties they have sold, which are fraudulently inflated, to legitimize the sales of other homes in the area for astronomical amounts. This results in an artificial inflation of home values in the area, which has the effect of pricing out other working-class, middle-income homebuyers. Moreover, the vast majority of the families who are targeted for property flipping schemes are nonwhite and the sales occur in nonwhite neighborhoods. This practice of targeting nonwhite families and neighborhoods for disadvantageous loans and home sales is called reverse redlining, and it is a violation of federal and state anti-discrimination laws.

We are currently litigating a number of property flipping cases, including the following case, which we brought in federal court in the Eastern District of New York. It is representative of the property flipping cases that we see.

Ms. W is a 68-year-old African American retired school aide, living on Social Security

[2] *See HUD-Treasury Report on Predatory Lending,* at 25 (visited March 28, 2003) <website: hud.gov/library/bookshelf18/treasrpt.pdf> (hereinafter "*HUD-Treasury Report*")

benefits, who sought to purchase her first home after being priced out of her long-term apartment. After seeing an advertisement in the newspaper for a one-stop shop, Ms. W called to make an appointment to see the homes that they were offering for sale. The one-stop shop promised to take care of all aspects of the home-buying process, including arranging for financing, a closing attorney, and a tenant to rent a part of the house. Ms. W gave the one-stop shop $20,000 - her entire life savings - as a downpayment. Ms. W was unaware that the property she was purchasing had been flipped: it had been bought by the one-stop shop only three months previously, and had been marked up by $169,000 for re-sale to Ms. W. Ms. W was also unaware that the house was fraudulently and intentionally overappraised by almost $150,000. She also did not know that the attorney that the one-stop shop arranged to represent her actually worked for the one-stop shop. The one-stop shop rushed Ms. W to close as soon as possible, and when she showed any signs of wanting to back out of the deal, the one-stop shop employees told her she would lose her downpayment. The loans she entered were completely unaffordable; indeed, the monthly mortgage payments of $3,367.73 far exceeded her income – she was promised that she could afford the loan based on the rental income in the property. After Ms. W moved into the property she began to realize the numerous problems with the transaction. For example, the repairs that the one-stop shop promised were not completed by the time of the closing, and Ms. W had to repeatedly call the company to ask them to finish the repairs. Ms. W also learned that her house was not a legal two-family property, which meant that the rental unit upstairs was illegal and she could not legally collect any rental income. Ms. W's life savings are now depleted, she is at risk of foreclosure and eviction, and her dream of homeownership is crushed.

The real victims of property flipping are the homeowners, the families that are targeted, and the communities in which they live. As a result of these predatory deals, vulnerable families face foreclosure, eviction, and financial ruin. The displacement caused by property flipping destabilizes entire communities. This is a widespread problem throughout the United States, and at SBLS we see hundreds of these types of cases each year. We ask that the Subcommittee on Housing and Community Opportunity fully address this issue from the perspective of the homeowners, not just the perspective of the secondary market. There are several immediate and concrete changes that could be made that would curb property flipping schemes; for example:

- For FHA-insured loans, HUD should commission an independent appraisal or appraisal review for every transaction. This would ensure the accuracy of the market value of the property and, without a fraudulent appraisal, property flipping would not occur. This makes sound fiscal sense, because fraudulent overappraisals drain the FHA insurance fund for illegitimate purposes.
- HUD should extend the current anti-flipping regulations, which currently prohibits FHA-insurance for homes bought and sold within ninety days, to prohibit insurance for homes bought and sold within six months.
- In 2003, HUD proposed a regulation that would have held originating lenders accountable for quality appraisals; although this regulation did not pass due to strong lobbying by the mortgage industry, this regulation should be pursued again because it would have had a significant impact on curbing property flipping. If

originating lenders were held accountable for their part in allowing originations based on fraudulent overappraisals, it would make it far more difficult for property flipping schemes to succeed.

- Lenders and companies that purchase conventional and FHA-insured loans should conduct appraisal reviews and search for red flags prior to purchasing the loans; indeed, if the secondary market didn't purchase these loans, it would cut off the capital to the originating lenders and property flipping would cease. Lenders should particularly scrutinize subprime loans and loans made in nonwhite communities when it is clear that a particular lender is targeting those communities for disadvantageous loans, and stop buying loans from companies that engage in these predatory tactics. This type of due diligence makes good business sense.

Thank you again for your invitation to provide testimony on this issue.

STATEMENT OF
KENNETH DONOHUE, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE UNITED STATES
HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON HOUSING
AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
OCTOBER 7, 2004

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OCTOBER 7, 2004

Chairman Ney, Ranking Member Waters and other members of the Subcommittee, it is my pleasure to testify before you today on the HUD Inspector General perspective on mortgage fraud and its impact on financial institutions.

My perspective on mortgage fraud is based on our work with HUD's Federal Housing Administration, commonly known as "FHA." As you know, there are three general types of mortgages: FHA insured, Veterans Administration guaranteed, and conventional. Of all homes purchased in the United States each year, 8% are financed with FHA mortgage insurance. Additionally, each year FHA accounts for 30% of all insured mortgages. FHA insured mortgages may be more prone to mortgage fraud because FHA insures mostly first-time homebuyers with limited credit histories and little money down. First-time homebuyers account for about 75% of FHA's new endorsement business and about half of its customers fall at, or below, the medium income in the area. Most of these FHA borrowers cannot qualify for a conventional loan.

HUD has a portfolio of nearly 5 million FHA insured mortgages with an unpaid principal balance of $418 billion as of the end of July 2004. For the first 10 months of fiscal year 2004, FHA endorsed about 875,000 mortgages. However, FHA activity has fallen off nearly 20% from the same period a year ago.

A closer look at the makeup of the FHA portfolio would indicate that FHA's insurance risk is increasing. A comparison of active insured FHA cases to FHA claims cases over the past two years shows an increasing claim

rate. The claim rate for fiscal year 2003 was 1.58%. This rate is up 74% from a .91% rate in fiscal year 2001. As you can see from our chart, our investigative workload is increasing with more than 450 open criminal single-family investigations and our arrests in the single-family mortgage area have increased by 800% in a four-year period. We believe there is a direct relationship between our increasing workload and FHA's increasing claims rate.

Additionally, more low down payment business is moving to the private sector. Whereby FHA was once the only low down payment mortgage available to borrowers, now the conventional marketplace has new mortgage products available to these borrowers. The borrowers beginning to use these new conventional products would normally be considered FHA's better customers.

Annual Financial Audit

The annual audit of the Federal Housing Administration's financial statement has found the FHA in basically sound fiscal condition. FHA continues to exceed its minimum capital ratio requirements as set by the Congress. This financial health has been brought about by a robust economy and mortgage premium income, which has far exceeded the cost of claims each year. Nevertheless, FHA's claims rate continues to rise each year and with fewer FHA mortgage applicants there is less premium income to cover the claims. The default rate (mortgages more than 90 days delinquent) for the FHA insurance-in-force portfolio has nearly doubled in the last five years, from 3% to almost 6%.

FHA's loss mitigation tools help many of these defaulted loans from moving to foreclosure. Loss mitigation usage is up 16% from a year ago. Despite these loss mitigation tools, however, we continue to see a rise in claims. A future economic downturn and/or future interest rate increases would provide opportunities for those who would prey upon homeowners who cannot make their mortgage payments.

Types of Mortgage Fraud in FHA Programs

In the recent past, we have conducted hundreds of audits of mortgage companies offering FHA loans and investigated thousands of cases of mortgage fraud. We repeatedly have found unlawful and deceptive practices

and outright fraud in mortgage lending that often exploit first-time and uninformed FHA borrowers. Some of these practices include:

- Appraisers valuing properties for much more than they are worth.
- Loan officers falsifying income and credit documents.
- Lenders charging fees for services not provided or unnecessary.
- Realtors deceiving the potential homebuyer of the property condition.
- Borrowers duped into re-financing their mortgages over and over until the equity is completely stripped from the property.
- Using stolen or purchased social security numbers and/or credit histories.

Of particular concern is the illegal profiteering on the purchase and quick resale of homes called "property flipping." The illegality arises because one or more parties to the transaction (seller, loan officer, appraiser) conspire to inflate the value of the home and then pocket the excessive profits at loan closing. What is the impact – who gets hurt?

- Once the borrower knows the true value of the property, they abandon the property.
- Neighborhoods deteriorate as the number of abandoned properties increase.
- Remaining homeowners are stuck making payments on inflated mortgages.

Another concern is "equity skimming." A common form of equity skimming involves an investor who exploits a homeowner facing foreclosure and other financial stress. How is this done?

- Investor offers to resolve the financial problems if the homeowner gives up ownership or an ownership share in the property.
- Homeowner agrees to pay rent to the investor and the investor promises to make the mortgage payments.
- Investor pockets the rent and makes no mortgage payments.
- Lender forecloses on the homeowner (investor's ownership interest not recorded).
- Investor uses bankruptcy laws to stay foreclosure.

Calculating Fraud?

Mortgage frauds can go undetected and not all fraud results in losses to the government. This makes it difficult to quantify the exact amount, or even an estimated amount, of mortgage fraud. The following scenarios highlight the difficulties -- for example: 1) the appraiser that was pressured by the lender for a higher appraised value to match the sales price; 2) the homebuyer that submits false down payment gift letters; 3) the seller that works a side loan with the buyer in order to make the deal work; or 4) the loan processor that overlooks a known debt that is not on the credit report. These things happen everyday and all would be categorized as mortgage fraud, and these can go undetected unless the borrower defaults on the loan, or there is a pattern of defaults associated with a particular lender, realtor, or appraiser. Complicating every case of fraud is proving the perpetrator did it intentionally and showing a significant loss to the Government.

If there are any significant miscalculations in the underwriting process, i.e., overstatement of income or understatement of debt, this would normally manifest itself in a payment delinquency on the mortgage. Every month, one out of every nine FHA mortgages is reported as delinquent. That means 600,000 FHA borrowers are a month behind in paying their mortgage. Some portions of these delinquencies may be due to mortgage fraud in new mortgages, where the underwriter intentionally misrepresented the borrower's ability to pay the mortgage.

We are continuously monitoring the status of defaulted loans in the FHA portfolio. These statistics are used by the OIG and the Department's Quality Assurance Division to identify specific lenders for review with above average defaults. We also provide outreach to the mortgage industry, talking with real estate agents, brokers, appraisers, lenders and servicers. We routinely receive referrals from one of these parties that are aware of fraudulent activities.

Some Examples of Specific Frauds

Below are two examples of combined OIG and FBI investigations of property flipping frauds and the results of a recent audit of mortgage fraud.

- **Chicago, IL.** ***The key players: an investor, an appraiser, and the settlement attorney.***

These three conspirators preyed on unwitting FHA borrowers in Chicago's south and west sides, saddling the new homeowners with overvalued properties and unmanageable mortgage debt. The fraud scheme was a typical flip. The investor would contract to purchase a property, recruit homebuyers, and then partner with a crooked appraiser and attorney to complete the resale and closing at an inflated price. The closings, some 70-80 properties, were done on the same day. The settlement attorney would close the sale to the FHA borrower first, then use the proceeds to pay off the first (and legitimate) seller, backdate closing documents to give the appearance of propriety, and ensure that all parties to the scheme were paid out of the FHA insured loan. *As you can see from the pictures on the easel, this example of one of the properties shows how significantly it declined in appearance and how it could potentially impact the surrounding neighborhood when one of these fraudulent transactions occurred.*

In the end, the investigation resulted in 20 people indicted on 16 different counts, including mail fraud, wire fraud and false statements to HUD. Eighteen individuals pleaded guilty. The attorney and the appraiser went to trial and were convicted on all counts. The attorney was sentenced to 7 years imprisonment and the appraiser received 40 months. HUD's cost: $7 million in insurance losses.

- **Stone Mountain, GA.** ***The key players: an appraiser and the settlement attorney.***

Earlier this year, a 158-count indictment was handed down in the Northern District of Georgia. The charges: wire fraud, bank fraud, money laundering, conspiracy, identity theft, use of false social security numbers and making false statements to HUD, all related to a mortgage fraud scheme involving a $20 million portfolio.

From mid-1999 through March 2004, it was alleged that the settlement attorney and co-conspirators perpetrated a property flipping scam. The attorney owned and operated a law firm, acted as agent for title insurance companies, and was the closing attorney for various lenders.

Again, the 'flipping' fraud was familiar. The defendants purchased residential properties primarily in the Stone Mountain, GA vicinity and resold them at artificially inflated prices, using the proceeds of the resale to pay for the initial purchase. The defendants would use identity theft or recruit "straw sellers" to falsely claim current ownership of the properties. The properties, in turn, were sold to straw borrowers at amounts fraudulently inflated. Put simply: the deals and documents were faked. The conspirators signed ghost or fake names as loan officers and processors of the mortgage company. They falsely notarized and witnessed the names of straw buyers and sellers who neither attended closings nor signed the closing documents. And, they created shell companies to falsify straw borrower employment, to receive scheme proceeds, and to pay, and otherwise, reward bank employees for providing false and misleading Verifications of Deposit. HUD's cost: $3 million in insurance losses.

- **Phoenix, Arizona Audit**

In a recent audit of an FHA-approved lender, we found the lender was fabricating or altering borrower credit and employment documents to make the loans approvable. In this audit we found pervasive document falsifications in 48 of 65 (74%) FHA loans originated by a HUD approved correspondent lender in the greater Phoenix metropolitan area. What was instructive about this audit was that only one loan officer was primarily responsible for originating the falsely documented loans. What is also alarming is the potential damage that resulted. The insurance value of these 48 loans exceeded $5 million. The lender ignored its responsibilities to HUD by not having a quality control plan in place. Consequently, this loan officer continued to originate FHA loans using false documents over a three-year period. In our opinion, performing quality control is the first line of defense in assuring that only qualified borrowers get loan approval. Sadly, for some lenders, quality control only becomes a concern after the auditors have detected the problem.

Conclusion

When we identify fraudulent transactions, we take a look at the cause of the problem. If additional controls are warranted, we make recommendations to the Department. If the problems result from criminal activity among parties to the FHA transaction, we present these matters to the US Attorney's office for prosecution. Problem lenders are brought

before HUD's Mortgagee Review Board for sanctions. There are many actions we can take if the fraud is brought to our attention. However, the mortgage industry is huge with millions of dollars of FHA loans being endorsed each day. Statistics are pointing to increased levels of risk. In the Office of Inspector General, we are making every effort to use our limited audit and investigative resources as efficiently and effectively as possible in combating mortgage fraud. We continue to work with our partners in the FBI and Justice Department, as well as with state regulatory and law enforcement agencies, to decrease mortgage fraud.

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Chairman Ney, I appreciate the Subcommittee's concern over the increasing problem of mortgage fraud. The result of these types of financial crimes undermines the confidence in this nation's housing industry and frustrates honest Americans' dreams for home ownership. In addition, the victims include the honest mortgage company employees that lose their jobs because they are victimized by the unsavory business practices of other staff, the homebuyers whose credit was destroyed when they had to default on a loan that they really could never afford in the first place, or the new FHA homebuyer that is paying a higher than necessary mortgage premium to cover growing losses to the insurance fund.

Thank you for the opportunity to express our views on this critical issue.

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Testimony before the United States House of Representatives Subcommittee on Housing and Community Opportunity

By
William Matthews
Mortgage Asset Research Institute, Inc., A ChoicePoint Service
Reston, Virginia

Chairman Ney, Ranking Member Waters and members of the subcommittee, my name is William Matthews and I am the vice president and general manager of Mortgage Asset Research Institute, Inc. also known as MARI, based in Reston, Virginia. MARI builds and maintains cooperative databases for the residential mortgage and financial services industries that are used to screen new business partners and relationships. I am pleased to testify today about mortgage fraud and its impact on mortgage lenders.

MARI was founded in 1990 and was acquired by ChoicePoint Services, Inc. in June of 2003. ChoicePoint, headquartered in the Atlanta area, is the leading provider of identification and credential verification services for making smarter decisions in a world challenged by increased risks. Serving the needs of business, government, non-profit organizations and individuals, ChoicePoint works to create a safer and more secure society through the responsible use of information while ensuring the protection of personal privacy. ChoicePoint recently celebrated its seventh anniversary as an independent company that is publicly traded on the New York Stock Exchange.

MARI's database, called the Mortgage Industry Data Exchange (MIDEX), was established on the premise that unethical and illegal activities in the residential mortgage industry could be significantly reduced though the responsible exchange of information among mortgage lenders, investors and insurers. MIDEX, a cooperative database, contains three basic types of information on companies and industry professionals:

1. Non-public incidents of alleged fraud, material misrepresentation and serious misconduct perpetrated by mortgage industry professionals and companies.

   These incidents are contributed by members of the cooperative database who include over 400 lenders, private mortgage insurance companies and mortgage investors.

2. Public sanctions and legal actions.

   These sanctions are collected from over 200 federal and state regulators in the mortgage, securities, commercial bank, real estate and appraisal industries.

3. State and federal licensing data for the mortgage and commercial banking industries.

   The licensing data comes from over 60 federal and state regulators.

Today, thousands of companies are searched each day through MARI's MIDEX database by members of this cooperative system in an effort to screen prospective and existing business partners.

Types of Mortgage Fraud

A basic industry definition of mortgage fraud is when a consumer or professional intentionally causes a financial entity to fund, purchase or insure a mortgage loan when the entity otherwise would not have done so if it had possessed the correct information.

There are three basic types of fraud in the residential mortgage industry:

1. Consumer fraud, or fraud for property, is perpetrated by borrowers when they misrepresent information on the loan application in order to purchase a more expensive home than one for which they would normally not qualify.

   Consumer fraud is relatively minor and does not usually result in significant losses to a financial institution.

2. Commission fraud is defined by one or more industry professionals misrepresenting information in a loan transaction in order to receive a commission on a loan that would not normally be acceptable to a lender.

   Commission fraud is a more common practice in the industry and is a concern to financial institutions. It can result in harm to the consumer and losses to lenders and insurers.

3. Fraud for profit consists of systematic transactions by industry professionals who are attempting to steal a significant amount of the funds associated with one or more mortgage transactions.

   This type of fraud usually involves multiple parties in various disciplines within the mortgage industry, such as mortgage originators, appraisers, real estate agents, closing agents, builders and title companies.

   Fraud for profit usually results in significant—if not catastrophic—losses to financial entities involved in mortgage loan transactions and is of major concern to the mortgage industry. A few examples of this type of fraud include land flips, fictitious lien releases and diversion of funds at closing.

Sample Incident of Mortgage Fraud

Let me give you an example of an incident in MARI's MIDEX database that typifies some of the problems and challenges that the industry is facing. In 1997, the National Association of Securities Dealers (NASD) debarred and fined a South Carolina stockbroker who received a $10,000 customer check and converted the proceeds for his own use. The broker, whom I will refer to as John Smith, subsequently became a loan officer with a national lender. Smith's employer ultimately suspected that Smith was engaged in fraudulent activities and, after reviewing approximately 500 loan files originated by Smith found that close to 20 percent contained inflated appraisals resulting in losses of approximately $2.5 million. Unbeknownst to Smith's employer, Smith started his own mortgage company at the same time he was working for the national lender. In August 2002, Smith pled guilty to wire fraud and received a sentence of five years probation.

This incident illustrates the need for proper hiring procedures within the mortgage industry and a central repository to track industry professionals found guilty of fraud from industry to industry or state to state or company to company.

How Prevalent is Mortgage Fraud?

How much fraud occurs in the mortgage industry and what is the cost of this fraud each year?

The answers are easy: The amount of fraud and its cost are unknown and, perhaps, unknowable at this time. The primary reason is that there is no central organization that collects this information. The closest we come to this is the Financial Crimes Enforcement Network ("FinCEN") which collects information from Suspicious Activities Reports ("SARs"). While FinCEN gathers information on mortgage fraud, the primary purpose of its data collection activities in the past has been to track money laundering. Also, the SARs only cover activities at federally insured financial institutions. A SAR is not required by state-chartered mortgage lenders that are not affiliated with an insured financial institution.

However, based on FinCEN statistics and information provided to MARI by its clients, the number of incidents of mortgage fraud is increasing and the types of incidents are becoming more severe and costly to the industry.

Ramifications of mortgage fraud to the industry range from monetary losses incurred by financial companies to destroyed professional reputations and even criminal and administrative actions. The financial losses incurred by a company can be catastrophic.

Ramifications to the consumer are higher loan rates and fees, stolen identities and possibly impaired credit ratings.

Ramifications to a neighborhood victimized by mortgage fraud can include higher property taxes, inability to sell homes, increased criminal activity and abandoned properties. It often takes years for a neighborhood to recover from the damage caused by mortgage fraud.

Mortgage Fraud Trends

I would like to point out some trends of alleged fraud and misrepresentation that occur in the residential mortgage industry in the United States. These trends were derived from incidents contributed to MARI's MIDEX database by a wide cross section of mortgage lenders, insurers and investors.

- During the past four years, there has been a shift in the states that have the greatest problems. Georgia and Nevada have caught up to and surpassed California and Florida as the states with the highest fraud scores.

  In the past, fraud rates from California and Florida have led the nation by a substantial margin. Florida and California continue to have high fraud scores, but Florida now ranks only third and California has slipped to eighth place behind Utah, South Carolina, Colorado and Illinois.
- Early payment default (EPDs)[1] information from LoanPerformance, Inc. indicates problems in several metropolitan areas and is consistent overall with the results reported by MARI's database subscribers.

[1] LoanPerformance defines an EPD loan as one that goes 90+ days delinquents in its first year.

Loans that become delinquent more than ninety days in their first year do not necessarily involve fraud. However, many such loans involve some form of misrepresentation and should probably not have been made.

- The types of problems found in loan fraud files (such as fraud associated with the application, tax returns and financial statements, appraisal, etc.) seem to have been relatively stable over the last four years.

Specific details and back up documentation for each of these trends is provided in the Appendix.

Conclusion

I appreciate the opportunity to testify on MARI's behalf regarding the impact fraud is having on the residential mortgage industry. Mortgage fraud is a significant problem. Based on submissions to MARI's database, it is not only increasing, but the types of fraud are becoming more severe. Fraud not only causes losses to financial institutions, it also causes higher prices to consumers. I would be happy to entertain any questions by the subcommittee.

Appendix

In the past, fraud rates from California and Florida have led the nation by a substantial margin. Florida and California continue to have high fraud scores, but Florida now ranks only third and California has slipped to eighth place. Table 1 below was developed from fraud cases submitted to MARI by MIDEX subscribers, and it shows that for loans originated[2] during the past four years, these two states have lost their distinction as the nation's leading hot spots.

Table 1

MARI Fraud Index (MFI)
By State
2000 through 2003

Rank	State	MFI
1	Georgia	250
2	Nevada	243
3	Florida	237
4	Utah	221
5	South Carolina	175
6	Colorado	160
7	Illinois	146
8	California	144
9	Maryland	132
10	Missouri	121
NA	Washington, DC	364

Source: Case submissions to the MIDEX system

A MARI Fraud Index (MFI) of 0 would indicate no reported fraud from a state. An MFI of 100 indicates that the reported fraud for a state is exactly what one would expect in terms of fraud rates given its population size (that is, a state with an MFI of 100 is "average").

[2] The dates used in MARI's Fraud Index are the loan origination dates. Subscribers to the MIDEX system may not discover that a loan involved fraud for months, or even one or two years, after it was originated. Therefore, these numbers are dynamic—especially the 2003 component.

Early Payment Defaults Indicate Possible Fraud

LoanPerformance, Inc.[3] collects monthly payment data on more than 42 million loans. An analysis prepared by the LoanPerformance staff is presented in Table 2 below. It shows prime loans' EPD scores for various metropolitan statistical areas (MSAs) around the country. (An EPD score of 100 indicates an area where EPDs are average for the United States.) The years designated by columns in Table 2 refer to the origination years. The ten MSAs listed in the first column of the table are those that have EPD rates at least twice the national average for the 2003 book of business.

The first six MSAs listed in Table 2 show steady and, in most cases, dramatic increases in their EPD rates over the past four years.

Table 2

LoanPerformance, Inc.
Data on Prime Loans
Early Payment Defaults
2001-2004

MSA	2004 Rank	2004	2003	2002	2001
Dallas-Ft. Worth	1 (tie)	300	284	239	187
Atlanta	1 (tie)	300	268	202	159
San Antonio	3	275	258	219	155
Jacksonville	4	250	137	118	106
West Palm Beach	5 (tie)	225	63	33	33
Newark	5 (tie)	225	158	116	135
Houston	7 (tie)	200	195	157	119
Miami	7 (tie)	200	137	75	58
Denver	7 (tie)	200	237	182	163
Kansas City	7 (tie)	200	116	116	119
Charlotte	7 (tie)	200	205	172	133
Salt Lake City	7 (tie)	200	295	200	208
Greensboro	7 (tie)	200	153	113	116

Source: LoanPerformance, Inc.

[3] Formerly Mortgage Information Corporation, aka MIC.

The LoanPerformance information for subprime loans is not sufficiently robust to be statistically valid for all MSAs. Therefore, it is aggregated by state. The ten states with LoanPerformance EPD scores of more than 175 are shown in Table 3 below.

Table 3

LoanPerformance, Inc.
Data on Subprime Loans
Early Payment Defaults
2001-2004

State	2004 Rank	2004	2003	2002	2001
Vermont	1 (tie)	267	109	138	80
West Virginia	1 (tie)	267	77	104	98
Georgia	3	242	175	113	92
Indiana	4	221	165	144	117
South Carolina	5 (tie)	188	174	171	146
Utah	5 (tie)	188	164	141	101
Minnesota	7 (tie)	183	158	123	94
Alabama	7 (tie)	183	127	101	89
Oklahoma	9 (tie)	179	176	144	124
Louisiana	9 (tie)	179	147	124	106

Source: LoanPerformance, Inc.

In most of the states listed in Table 3, the 2003 subprime EPD rate has risen significantly over the past four years. Several of the states with the highest 2003 EPD rates have seen this problem almost double. Vermont, West Virginia, Georgia, Minnesota and Alabama started out with EPD rates below the national average in 2001.

While EPD scores do not necessarily indicate fraud, the conclusions that can be drawn from the LoanPerformance data are consistent overall with the results reported by MARI's database subscribers.

Types of Fraud Reported

MARI's MIDEX system classifies the types of alleged fraud involved in each incident reported by its cooperating subscribers. These classifications are shown in Table 4 for loans originated in the four-year period from 2000 through 2003. The data on 2003 loans is very preliminary since frauds perpetrated in 2003 will continue to surface for another two years or more.

Table 4 shows the percentage of each fraud classification, as drawn from the information on all fraud cases submitted to the MIDEX database. For instance, 63% of the incidents of fraud reported to the database for mortgages originated in 2003 contained application fraud. (This is not surprising given the comprehensive nature of the application form.)

Table 4

Mortgage Fraud Trends				
Fraud Classification	**Mortgage Origination Year**			
	2003	**2002**	**2001**	**2000**
Applications	63%	64%	66%	60%
Tax and Financial Statements	31%	27%	24%	25%
Verifications of Employment	12%	14%	16%	19%
Verifications of Deposit	14%	16%	16%	21%
Escrow/Closing	9%	18%	17%	20%
Appraisals/Valuations	15%	25%	22%	26%
Credit Reports	1%	1%	2%	2%

Source: Case submissions to the MIDEX system

There appear to be few discernable patterns or trends in the data for this four-year period. However, it is interesting to note that the total percentage for each year (the sum of each column in Table 4) exceeds 100%. This is because most reported incidents involve more than one type of fraud.

Appraisal Fraud

Even casual observation of Table 4 indicates that the amount of appraisal fraud reported is somewhat lower than one might expect in each of the years, especially in 2003. The low levels of reporting can be tied to the fact that, typically, reported incidents involve more than one type of fraud. If the reporting lender finds misrepresentation in the VOE and in occupancy status, that lender is not likely to spend the funds necessary to verify appraisal fraud, even if the appraisal appears to be invalid.

Some MIDEX subscribers indicate that attempts at appraisal fraud are much higher than Table 4 shows, but some loans are not closed due to the faulty appraisal's comparison to the values produced by an automated valuation system.

STATEMENT

of

Marta McCall
Senior Vice President for Risk Management
American Mortgage Network Inc.

on

"Fraud in our Nation's Mortgage Industry"

before the

Subcommittee on Housing and Community Opportunity

Committee on Financial Services

United States House of Representatives

October 7, 2004

Good morning, and thank you Mr. Chairman, for holding this hearing and inviting the Mortgage Bankers Association (MBA)[1] to share its views on mortgage fraud and the growing threat it poses for this country's real estate finance system. My name is Marta McCall and I am the Senior Vice President for Risk Management at American Mortgage Network Incorporated in San Diego, California.

I have been in the mortgage industry for over 28 years and have been involved in helping the companies I have worked for, and the mortgage industry as a whole, detect, prevent, and prosecute mortgage fraud. I have twice served as Chair of MBA's Quality Assurance subcommittee and once as Chair of the California MBA Quality Assurance committee.

MBA has come before this committee many times and testified about the sophisticated real estate finance system in the U.S. and the innumerable benefits it has provided to the American public. Nowhere is this sophistication more evident than in the residential mortgage market.

Organizations that once dominated the delivery of home financing to families, such as savings and loans or the Federal Housing Administration (FHA), have given way to a complex system of many specialized organizations working interdependently to make the efficient and low-cost delivery of home loans possible. The result is that home-financing is available where and when it is needed anywhere in the U.S.

Consumers have been the primary beneficiaries of this complex system. Our residential finance system, though intricate, has created more mortgage products than ever before, reaching more homebuyers than ever before. Complexity has bred efficiency, and efficiency has lowered costs.

Complexity has also impaired the industry with a shadow, and this shadow is mortgage fraud. Mortgage fraud is the growingly pervasive dark side of our residential mortgage system that costs the industry and consumers millions, and possibly billions, of dollars each year. Today, mortgage industry leaders are extremely concerned that this shadow has grown quite large in the past several years with the consequences devastating to lenders, taxpayers, consumers and communities.

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[1] MBA is the national association representing the real estate finance industry. Headquartered in Washington, DC, the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,800 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's website: www.mbaa.org.

What is mortgage fraud?

The industry defines mortgage fraud as material misrepresentation- the giving of false information that deceives or misleads a lender into extending credit beyond the limits of what would normally be extended if the facts were known. Information or documentation is considered false if there is clear and convincing data that the information or documentation lacks truth or accuracy. Simply put, a mortgage lender would not have made the loan, or at least not under the same terms, without the fraudulent information.

The industry divides fraud into two broad categories: "fraud for property" and "fraud for profit." Fraud for property occurs, typically, when a homebuyer or other party defrauds the system so they can purchase a house for their own use. Such fraud usually carries a lower financial risk to lenders because the fraud is a one-time occurrence on a loan the buyer intends to repay.

Fraud for profit schemes are much more far reaching and usually involve a person or groups of people who abuse the system for financial gain. These criminals are often industry insiders who know how to exploit our complex system at the expense of lenders, taxpayers, consumers, and communities.

Lenders are victimized by fraud

As an example, a small mortgage company with a good reputation in the southwest was defrauded by a single loan officer. The company discovered the fraud, notified FHA, who forced the company to indemnify the fraudulent loans. The loan officer was debarred from FHA programs for one year and has since worked for other companies and is still in the industry. The company, on the other hand, unable to absorb the losses on the indemnifications was forced to close. Owners who had built up the company lost their investment and their employees lost their jobs.

Taxpayers suffer from fraud schemes

In one of the most costly and elaborate fraud schemes to date, two couples were convicted in North Carolina for defrauding the Government National Mortgage Association (Ginnie Mae). Among other activities, the scheme involved the creation of fake mortgages that were then sold to Wall Street investors as the real thing.

The couples obtained "straw buyers" – individuals who are paid for the use of their names and Social Security numbers to obtain a mortgage – and used proceeds from the loans, often for homes that did not exist, to benefit a mortgage company owned by one of the couples. More than $5 million in false notes were sold on the secondary market, but once discovered that the notes were false, the investor ordered the mortgage company to buy back the loans. Instead of repaying the investor, the criminals pooled the notes into mortgage securities, backed by Ginnie Mae, and sold

them to investors. Once the scheme had been discovered, investigated and prosecuted, it was estimated that taxpayers were bilked out of more than $35 million.

Homebuyers are victimized by fraud

An FBI press release on September 17th of this year prompted a call to MBA by a woman who recounted her story as a victim of fraud. She is a single mother who was convinced to purchase her first home by an associate who, without her knowledge, conspired with the appraiser to over-value the home. She discovered the fraud when she went to refinance the home and found that the mortgage she currently had on the property far exceeds the property's value. She is stuck with a mortgage that can't be refinanced nor can she sell the property to pay off the mortgage. The lender is left with a loan only partially secured by the property.

Neighborhoods suffer from fraud schemes

Whole neighborhoods can be devastated by schemes that cause homes to be foreclosed and abandoned. In East St. Louis, IL, a property management company ran a flipping scheme between 1997 and 2002 that involved 85 properties in an economically depressed area.

In this scheme, the individual purchased dilapidated homes and sold them to unqualified borrowers after obtaining falsely inflated appraisals. Numerous mortgage companies were defrauded by false gift letters, appraisals, W-2s, verifications of employment and rent, and backdated bonds for deeds. The fraud scheme netted approximately $4.2 million in revenue for the criminals and caused approximately $2.3 million in losses for lenders. The neighborhood was left with a concentration of foreclosures and abandoned properties.

As you can see, fraud schemes are limited only by the imagination of those who perpetrate them. While stories of fraud abound in the mortgage industry, no authoritive statistics are available on the extent or the cost of the problem. Many people try to make educated guesses at the amount of mortgage fraud, but these numbers cannot be validated. To date, the best indicators of a growing problem are developed based on investigations by law enforcement and reports required of depository institutions under the Suspicious Activity Reports (SAR) requirement.

The FBI has announced that it currently has 533 pending mortgage fraud investigations, compared with 102 in 2001. SARs data for the same time period shows that banks have reported more than 12,100 instances of suspicious activity in the first 9 months of 2004, compared with only 4,220 in all of 2001. These numbers clearly demonstrate an increase in mortgage fraud. Given the limits of data though, MBA believes that these numbers understate the problem.

Mortgage industry response to mortgage fraud

Lenders spend large amounts of money in detecting and preventing mortgage fraud during the entire mortgage lifecycle. Before even taking an application, prudent lenders investigate the parties they do business with, such as brokers, appraisers, and title companies. Lenders' quality assurance personnel consult internal and external lists of debarred individuals and companies. During the loan origination process, lenders independently verify information provided by the borrower. Additionally, lenders review third-party reports, such as appraisals, to catch fraud. Some lenders additionally employ electronic reviews of data, such as Automated Valuation Models (AVMs), that attempt to validate the appraisal's determination of value and check for fraud red flags.

The huge sums lenders spend on detecting and preventing fraud prior to closing are necessary for mortgage companies in our current system because lenders bear practically all the risk of fraud. The secondary market investors who purchase mortgages all require that, if they find fraud, the mortgage company that sold them the loan must repurchase it. Mortgage companies find these repurchases extremely expensive, as many are not equipped to service the loan and therefore must resell the loan at a significant loss.

Given that the problem of mortgage fraud is widespread and that the risk falls primarily upon mortgage lenders, I would like to advance three principles that require the attention of this committee and law enforcement:

1. **Investigation and prosecution of mortgage fraud by law enforcement agencies needs to increase.**

   MBA applauds the recent announcement of actions taken by the FBI's Financial Crimes Section in investigating and prosecuting mortgage fraud. Mortgage lenders victimized by fraud are more than willing to provide information and assist in the investigation of mortgage fraud they uncover, but these same lenders get frustrated when cases are not prosecuted. Too many resources are invested by mortgage companies in staffing fraud units and pursuing investigations to have their work shelved without legal action.

   Additionally, mortgage lenders find it very hard to recoup their losses, and sometimes can only do so if they file a civil suit, a costly process. The criminals are often quickly back on the street with a new company or in a different state, defrauding others.

   MBA believes there is no substitute for strong law enforcement that aggressively prosecutes those who commit mortgage fraud and sends a clear message to those who contemplate it.

2. **Communication between mortgage lenders and the state and federal agencies that investigate and prosecute mortgage fraud needs to improve.**

   A large complaint from mortgage lenders that report fraud is the lack of communication or follow-up from law enforcement. While we understand that prudent policies prevent law enforcement from commenting on open investigations, we believe that there are other ways to improve communication. The current system is viewed by lenders as unidirectional- mortgage lenders report fraud, but never hear back about their reports. A feedback mechanism could benefit both lenders and law enforcement. Lenders could implement internal policies based on the feedback as well as provide additional support to law enforcement based on the feedback received.

   MBA has begun working closely with the FBI to discuss tools that could be developed that would enhance communication, such as regular reports from law enforcement to the industry summarizing the types and locations of reported frauds they are receiving. While we understand that the FBI has competing concerns for limited resources, MBA believes that through enhanced communication, the industry can assist federal and state regulatory agencies apply their limited resources more efficiently. Steps have been made in this direction and we applaud the willingness to date of the law enforcement agencies we have worked with to pursue this type of communication with the industry.

3. **The mortgage industry needs to continue to develop better industry tools and intra-industry communication to combat fraud.**

   As you will hear from some others testifying here today, the residential mortgage industry has invested large sums into systems and projects to detect and prevent mortgage fraud. Automation in the industry has allowed for improved detection tools and reduced investigation time.

   The industry, though, needs the help of policymakers in further developing these tools. I would like to highlight three issues as examples of the problems lenders face in using and developing tools:

   - Many states have loan originator licensing or registration laws whose purpose, in part, is to track loan officers, brokers, and appraisers. The goal of these policies is better oversight. Unfortunately, there is a lack of uniformity among these state efforts, which can lead to loopholes that criminals can exploit in moving from one state to another. MBA believes that this patchwork system should be examined for potential improvements.

   - Communication between mortgage lenders is hampered by the fear of law suits if one company discloses to another the results of its investigations into

fraud. Some form of "safe harbor" is critical for the type of communication necessary for the industry to protect itself, and consumers, against fraud.

- Unlike credit and economic risk, the responsibility for mortgage fraud is borne fully by mortgage lenders. Secondary market investors require repurchase of loans when fraud is discovered. Lenders though, as victims of fraud, typically have no practical recourse to those who perpetrate fraud as they are either out of business or have little capital from which to sue for losses.

These are just three examples of the issues that MBA is grappling with in developing tools that will allow for the industry to adequately address fraud.

On behalf of MBA, I would like to thank the committee for the opportunity to testify here today. The mortgage industry looks forward to working with Congress and Federal and state agencies in furthering collective efforts to combat mortgage fraud.

STATEMENT

OF

ARTHUR J. PRIESTON, CMB
CHAIRMAN, THE PRIESTON GROUP

"MORTGAGE FRAUD AND ITS IMPACT ON MORTGAGE LENDERS"

BEFORE THE

SUBCOMMITTEE ON FINANCIAL HOUSING AND COMMUNITY OPPORTUNITY

UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 7, 2004

Introduction

Good morning Chairman Ney, Vice-Chairman Green, Congresswoman Waters, and distinguished members of the subcommittee. My name is Arthur Prieston. I am Chairman of The Prieston Group (TPG), and Senior Partner and Chairman of the Mortgage Banking Group of the law firm of Lanahan & Reilley, LLP a national firm based in Santa Rosa, California. I have been involved in the mortgage industry all my professional life, first as an attorney specializing in mortgage fraud civil prosecution, and now as provider of the only fully integrated suite of mortgage fraud protection, mitigation and indemnification services in the industry.

I was co-founder and co-chair of the Subcommittee on Fraud for the Mortgage Bankers Association (MBA), co-founder of the Legal Services Subcommittee on Fraud for the California MBA, and co-chair of the Legal Services Committee for the CMBA, among many other industry affiliations. I have also been the featured speaker at a number of key conferences and conventions. I have authored many articles in industry and trade publications, and co-authored the MBA's definitive book, *Mortgage Fraud: The Impact of Mortgage Fraud on Your Company's Bottom Line.* I have also been distinguished by the MBA with the designation of Certified Mortgage Banker (CMB).

The Prieston Group, through our LoanCert division, protects hundreds of lenders across the country with mortgage pre-funding quality control and due diligence, fraud detection and prevention training, and ongoing education in quality lending and best business practices. Through our PBIS Insurance Services division, TPG protects against fraud with our Lender Representation and Warranty Insurance coverage.

Through our affiliation with Lanahan & Reilly, TPG mitigates losses associated with mortgage fraud. We have assembled one of the strongest, most experienced mortgage banking practices in the country dedicated to the eradication of mortgage fraud. The attorneys on my team are specialists in loss

mitigation, fraud investigation, recovery analysis, foreclosure, demand management, and litigation. Our clients include major banks, thrift institutions, mortgage companies, secondary market investors, securities issuers, and other financial services companies.

In the past two years the combined resources of The Prieston Group are protecting over $50 billion in residential loans, and have resolved and or paid in excess of $40 million in losses due to mortgage fraud on behalf of our clients making TPG the largest mortgage fraud insurance provider in the nation.

Given the breadth and depth of our involvement in the industry -- educating lenders, insuring loans, paying claims as a result of fraudulent mortgage loan practices, and going after the perpetrators – I believe The Prieston Group is uniquely positioned in our industry, enabling me to bring to the committee today equally unique testimony about fraud's impact on the lender, and the legal constraints faced by lenders as they attempt to recover losses from the fraudulent parties that often escape punishment and prosecution.

The pervasiveness of mortgage fraud and its increasing impact on our industry is a direct consequence of the extraordinary speed of growth and demand on a real estate financing delivery system that is both complex and faceless. At the same time, the remedies available to address these attacks on lenders and borrowers by sophisticated mortgage fraudsters are antiquated and ineffectual. As discussed further in this testimony, complex mortgage fraud schemes, the most damaging, are necessarily dependent on third parties to the transaction. It is these parties, such as appraisers and settlement agents, among others, who can, if held accountable, prevent mortgage fraud; but in many cases, have no liability for losses due to mortgage fraud. As the industry becomes increasingly dependent on their services, these parties should have both a duty and a liability to protect the consumer and the lender alike.

Mortgage Fraud Defined

Fraud for Property: Also referred to as Fraud for Housing – Misrepresentation and/or concealment in order to qualify for a loan. The borrower is a knowing participant and has every intention of making the loan payments. This type of fraud often goes undetected for the life of the loan if the borrower is making the scheduled monthly payments. However, many borrowers cannot afford the loan and predictably default. Less in numbers, there is less of a financial impact on the lenders than fraud for profit activities.

Fraud for Profit: Elaborate schemes involving multiple parties (mortgage broker, realtor, appraiser, closing attorney/settlement agent, title company) often perpetrated against numerous lenders simultaneously. Fraud for profit is more costly than fraud for property and includes flipping and chunking. The fraudsters who create such conspiratorial enterprises are savvy and cunning, capable of affecting a large geographic area in one complex scam.

The Extent of Mortgage Fraud

The extent of some form of misrepresentation in the residential market has long been estimated at 10% of all loan applications. While this number is commonly quoted and accepted as fact, the truth of the matter is that the industry has been unable to unequivocally substantiate that statistic. The extent of fraud varies depending on geographic location, origination channel of the loan, lender's commitment to quality originations and the accountability of all participants in the transaction

Historically, we know that a high propensity of fraud occurs in urban markets. The more notable markets at the current time include Chicago, Cleveland, Atlanta, Salt Lake City, Brooklyn and Detroit – to name just a few.

Nonetheless, mortgage fraud is not only here to stay, its incidence is becoming more widespread. Within the experience of The Prieston Group for instance, our insurance claims have risen over 40 percent in the last year. This we believe is attributed to an increased awareness of successful methods and techniques to commit fraud. Left unabated, we believe mortgage fraud will continue to grow in geometric proportions.

The Victims of Mortgage Fraud

Mortgage fraud affects all those who are involved directly and indirectly with the loan transaction. Borrowers of course in many instances are the primary victims. In many for-profit schemes, borrowers are "duped" into providing financial data, identity or in many circumstances falsely advised as to the insignificance of the fraud, and that lenders are not affected so long as payments are made. Lenders are affected, sometimes resulting in closure of the business. Our firm has represented over one hundred small business or family operated mortgage lenders employing tens of thousands of people who have been driven to the brink of business failure as a result of having to repurchase fraudulent loans.

Take the following example:

We recently consulted with a small lender in Florida. This family owned lender had been in business for less than ten years, funded approximately fifteen loans each month and employed eight people. Until last year, this company prided itself on its loan quality and had good relationships with its secondary market investors. Then in 2003, the company was hit with seven repurchase demand letters from one of its investors as a result of unknowingly making loans that were part of a fraudulent flipping and chunking scheme in Indianapolis.

Concerned about the situation, the lender contacted the investor for details and learned of another fifteen fraudulent loans the investor was auditing. All 22 loans were brought to the lender by the same mortgage broker. Over 2.2 million dollars in losses caused the lender to shut its doors.

Predatory Lending vs. Mortgage Fraud

Mortgage fraud, in its current industry context, does not include predatory lending per se, but rather relates more specifically to the types of fraud perpetrated on lenders and borrowers alike.

Predatory lending legislation is intended to address the scam artists who rip-off unsuspecting borrowers with abusively high cost loans. In many instances such loans fall into the sub-prime credit classification for no reason other than the interest rate associated with that loan. Notwithstanding the definitional confusion associated with predatory lending and the types of lending practices it is intended to prevent, mortgage fraud affects all loans alike, both prime and sub-prime loans.

Can predatory lending practices be considered acts of mortgage fraud? Yes, but most statutes do not directly address, prevent or provide remedies for the types of fraud, such as flipping, occupancy, application and appraisal that are the most prevalent.

Industry Acts to Identify and Prevent Fraud

As in all industries, good business practices utilizing the types of tool sets you have heard today will assist in prevention and detection of problem loans.
In addition, many lenders maintain rigorous standards for preventing fraud through automated detection systems, hands on re-verification of financial data and re-reviewing property values. They have pursued claims against all participants in the fraud, on both a criminal and civil level with mixed results.

Although we support the recent actions by the FBI and Department of Justice to promote the prosecution and deterrence of mortgage fraud perpetration, there is

no better tool to prevent such actions than by hitting all those contributing to the fraudulent transaction where it hurts: in their pocketbook.

In many of these fraudulent residential mortgage loan transactions, but for the participation of third parties, such as appraisers and settlement agents, the fraud would never have succeeded. However, as a result of current laws in various states, these particular parties are immune from liability.

Appraiser Liability

Appraisers can be liable for their negligently prepared or fraudulent appraisal. However, a successful action against a wrongdoing appraiser is dependent on (1) the state in which the action is brought, (2) the type of action brought against the appraiser i.e. negligence or misrepresentation, and (3) whether the lender bringing the action retained the appraiser.

In the wholesale mortgage delivery process, appraisals are generally provided to the lender through the mortgage broker. There are two separate and distinct legal lines of authority that address the issue of whether the lender can maintain an action for recovery against a broker-hired appraiser for preparing a fraudulent appraisal.

In a typical fact pattern, the original appraisal is ordered by the mortgage broker. Upon completion of the appraisal, it is submitted to the lender by the mortgage broker. Submission of the appraisal report to the lender is a standard and well established custom and practice in the loan industry, as well as an express requirement under investor guidelines in determining whether a particular loan can be approved. Equally customary in the industry, is the lender's reasonable and justifiable reliance on the appraisal report and valuation in making its decision to approve and fund the loan. However, based on subsequent, post-

close of escrow reviews it is discovered that the appraisal was fraudulently prepared.

In some states such as California and Texas, the courts have adopted the Restatement 2nd of law, 552(1) "one who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information."

Not all states subscribe to the Restatement analysis however. Most states have followed a line of cases that is contrary to the California conclusion on the issue of the connection, or nexus, between the appraiser and the lender stating that in the context of a wholesale transaction there is insufficient "privity" between the lender and the appraiser for the lender to be able to bring an action against the appraiser for negligence or fraud.

There is a need for uniformity, where appraisers who work exclusively in the residential mortgage delivery system are accountable for fraudulently prepared appraisals to those who clearly rely upon them: the borrower, the lender and the secondary market.

Flip Transactions and the Settlement Agent

A flip transaction in and of itself is not illegal. Quite commonly, these legal transactions involve individuals or companies that have purchased foreclosed properties at lower than current value prices, and/or have added cosmetic repairs to the property and resell those properties for relatively modest profits. However, the "illegal flip" involves a somewhat different fact pattern. There, the perpetrator contracts to purchase a property. Many of these properties are HUD properties recently foreclosed upon and have very little value. The "buyer" then obtains an

inflated appraisal from a co-conspirator appraiser. The financial credit used for loan approval is fabricated or misrepresented. The property is then sold to either an innocent third party who is left with a house he or she cannot afford, or to a straw-buyer, simply an alter ego for the perpetrator. Patience is not the virtue of these "flippers," who often flip the property within days or even hours after the original purchase.

In many instances, settlement agents are acutely aware of when a flip transaction is about to occur. This is a result of their knowledge of contemporaneous transactions coupled with their knowledge of a contract of sale indicating extraordinary increases in the subject property's value. They are aware of sources of down payments, or that the alleged borrower does not exist. Settlement agents are the lynchpin to the fraud transaction. However, to date there are no "flip" statutes affirmatively requiring the agent to disclose their knowledge or suspicion of the flip to the lender. In fact, many settlement agents have taken the position when sued, that flips are perfectly legal. In one case, the settlement agent's expert witness testified that there is no obligation on the part of the settlement agent to discover or disclose the nature of the transaction notwithstanding the fact that the property had increased in value by over 150 percent within minutes. Settlement agents have invariably claimed that they have limited responsibilities in the escrow process. It is their position that their duties are to obtain signatures, disburse funds and, in the case of title companies, record documents, and not to report on suspicious activity.

We believe that agents must not close their eyes in the face of known facts that are intended to be deceptive, and then console themselves with the thought that no one has yet confessed fraud.

Conclusion

As I hope members of the Committee have seen in my brief statement today, mortgage fraud is a serious problem not just in my industry, but in the economic

lives of all Americans. Mortgage fraud is so devastating because it is so insidious: people often don't know when it has victimized them – until it is too late. And many other people, the majority of consumers I imagine, assume that the costs of mortgage fraud – when they even recognize the problem – are borne by those few individuals who unwittingly allow them to be victimized or who are caught by their own greed. The fact is, mortgage fraud carries a financial penalty that reverberates throughout our economy – we all end up paying the price for mortgage fraud one way or another, either directly or through higher fees or insurance costs or other "hidden taxes."

And that is perhaps the most salient condemnation of all: mortgage fraud often affects most, those who can afford it least. The innocent and ill-informed are the easiest prey for the professional fraudster. The economically distressed are the most vulnerable to the false promises of unscrupulous hucksters. Mortgage fraud is most assuredly not a "victimless crime." And I support the actions of this Committee, that has recognized mortgage fraud for the dangerous blight that it is, and hope that we do everything we can – through legislation, enforcement, and prevention – to eradicate it.

On behalf of myself, The Prieston Group, and the mortgage banking industry, I thank you for your time and attention.

United States House of Representatives
Committee on Financial Services

Truth in Testimony Disclosure Form

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information, a copy of which is attached to my written testimony being filed with the Clerk of the Committee.

Name:	Arthur J. Prieston
Organizations I am Representing:	The Prieston Group Lanahan & Reilley, LLP
Business Address and Telephone:	The Prieston Group 4040 Civic Center Drive Suite 200 San Rafael, CA 94903 (800) 523-7713 ext. 201

I have not personally received any Federal grants or contracts (including subgrants and subcontracts) since October 1, 2000 related to the subject on which I have been invited to testify.

None of the organizations I am representing have received any Federal grants or contracts (including subgrants and subcontracts) since October 1, 2000 related to the subject on which I have been invited to testify.

Signature

Statement of

Chris Swecker

Assistant Director

Criminal Investigative Division

Federal Bureau of Investigation

Before the

House Financial Services

Subcommittee on Housing and Community Opportunity

October 7, 2004

Introductory Statement:

Good morning Mr. Chairman and Members of the subcommittee. I want to thank you for the opportunity to testify before you today about the FBI's efforts in combating mortgage fraud. Although there is no specific statute that defines mortgage fraud, each mortgage fraud scheme contains some type of "material misstatement, misrepresentation or omission relied upon by an underwriter or lender to fund, purchase or insure a loan." The Mortgage Bankers Association (MBA) projects $2.5 trillion in mortgage loans will be made this year. The FBI compiles data on mortgage fraud through Suspicious Activity Reports (SARs) filed by financial institutions, and Department of Housing and Urban Development Office of Inspector General (HUD-OIG) reports. The FBI also receives complaints from the industry at large.

A significant portion of the mortgage industry is void of any mandatory fraud reporting. In addition, mortgage fraud in the secondary market is often under reported. Therefore, the true level of mortgage fraud is largely unknown. The mortgage industry itself does not provide estimates on total industry fraud. The industry provides incomplete or inconsistent fraud data. Based on various industry reports and FBI analysis, mortgage fraud is pervasive and growing.

The FBI investigates mortgage fraud in two distinct areas: Fraud for Housing and Fraud for Profit. Fraud for Profit is sometimes referred to as "Industry Insider Fraud" and the motive is to remove equity, falsely inflate the value of the property or issue loans based on fictitious property(ies). Based upon existing investigations and mortgage fraud reporting, 80% of all reported fraud losses involve collaboration or collusion by industry insiders. These schemes involve industry insiders to override lender controls. Fraud for Housing represents illegal actions perpetrated solely by the borrower. The simple motive behind this fraud is to acquire and maintain ownership of a house under false pretenses. This type of fraud is typified by a borrower who makes misrepresentations regarding his income or employment history to qualify for a loan.

For the past 18 months, the FBI has been evaluating the effectiveness of its national mortgage fraud program. In June 2004, I authorized the consolidation of the mortgage fraud program into the Financial Crimes Section of the FBI's Criminal Investigative Division. Previously, mortgage fraud that impacted government programs (i.e.HUD) was managed by the Integrity in Government Section. Mortgage fraud affecting financial institutions was managed by the Financial Crimes Section. This consolidation provides the FBI a more effective and efficient

management over mortgage fraud investigations. Second, I encouraged an overall strategy to addresses mortgage fraud on a proactive basis utilizing partnerships with federal agencies, state and local law enforcement, regulatory bodies, and private industry. Third, I assured adequate personnel resources were dedicated to emerging mortgage fraud problems in regions of the country encountering the greatest levels of fraud. And finally, the FBI adopted an overall strategy to focus on insiders harming the industry in order to disrupt and dismantle entire criminal enterprises.

The FBI defines industry insiders as appraisers, accountants, attorneys, real estate brokers, mortgage underwriters and processors, settlement/title company employees, mortgage brokers, loan originators and other mortgage professionals engaged in the mortgage industry. Through a mandatory reporting mechanism, industry insiders would be the front line in preventing mortgage fraud. Zero tolerance within the industry combined with a mandatory system of reporting fraudulent activities to the FBI and HUD will be a major step in addressing mortgage fraud.

The defrauding of mortgage lenders should not be compared to predatory lending practices which primarily affect borrowers. Predatory lending typically affects senior citizens, lower income and challenged credit borrowers. Predatory lending forces borrowers to pay exorbitant loan origination/settlement fees, sub prime or higher interest rates, and in some cases, unreasonable servicing fees. These practices often result in the borrower defaulting on his mortgage payment and undergoing foreclosure or forced refinancing. As one example, in 2002

and 2003, FBI, HUD-OIG and state and local agencies from Utah pursued allegations that Fairbanks Capital Corporation was engaged in predatory servicing practices. This particular case culminated in civil and other administrative actions taken by the Department of Justice.

Market Impact:

The potential impact of mortgage fraud on financial institutions and the stock market is clear. 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. Investors may lose faith and require higher returns from mortgage backed securities. This may result in higher interest rates and fees paid by borrowers and limit the amount of investment funds available for mortgage loans.

Often times, mortgage loans are sold in secondary markets or are used by financial institutions as collateral for other investments. Repurchase agreements have been utilized by investors for protection against mortgage fraud. When loans sold in the secondary market default and have fraudulent or material misrepresentation, loans are repurchased by the lending financial institution based on a "repurchase agreement." As a result, these loans become a non performing asset. In extreme fraud cases, the mortgage backed security is worthless. Mortgage fraud losses adversely affect loan loss reserves, profits, liquidity levels and capitalization ratios, ultimately affecting the soundness of the financial institution.

Proactive Approach to Mortgage Fraud:

Over the past five years, the FBI has implemented new and innovative methods to detect and combat mortgage fraud. One of these proactive approaches was the development of a property flipping analytical computer application, first developed by the Washington Field Office, to effectively identify property flipping in the Baltimore and Washington areas. The original concept has evolved into a national FBI initiative which employs statistical correlations and other advanced computer technology to search for companies and persons with patterns of property flipping. As potential targets are analyzed and flagged, the information is provided to the respective FBI field office for further investigation. Property flipping is best described as purchasing properties and artificially inflating their value through false appraisals. The artificially valued properties are then repurchased several times for a higher price by associates of the "flipper." After three or four sham sales, the properties are foreclosed on by victim lenders. Often flipped properties are ultimately repurchased for 50-100% of their original value.

Other methods employed by the FBI include sophisticated investigative techniques, such as undercover operations (UCO's) and Title III wire taps. These investigative measures often result in collecting valuable evidence and provide an opportunity to apprehend criminals in the commission of their crimes and reduce losses to financial institutions. These proactive methods do not preclude historical investigations; however, they provide the FBI with additional tools to conduct large scale investigations through operational efficiencies.

In August 2002, the Cleveland FBI Office culminated a two-year UCO targeting industry

insiders. The UCO focused on mortgages settled by American Home Loans employees and corrupt professionals including appraisers, accountants, mortgage brokers and loan originators. Representatives of American Home Loans were able to orchestrate the scheme by fabricating loan applications and the supporting documentation (W-2s, tax returns, employment/income and bank verifications). As a result, industry insiders were able to circumvent the safeguards of numerous finance companies. The pervasive loan fraud caused property values to be artificially inflated in the greater Cleveland area. Through this UCO, more than 150 targets were identified, 23 search warrants were executed, and 94 targets were indicted, including two accountants, four title company employees, five appraisers, eight underwriters and forty loan brokers.

On September 16, 2004 an undercover mortgage fraud investigation conducted by the FBI Charlotte Division resulted in the identification of more than 35 industry insiders, and more than 380 fraudulent loans exceeding $70 million. In November 2002, the investigation was initiated due to numerous complaints by the North Carolina State Bureau of Investigation and lenders regarding high loan default rates within a short period of time. The FBI identified a pattern of pervasive mortgage fraud in the greater Charlotte area. The investigators determined the most efficient and effective approach to this investigation was an UCO. This not only resulted in the identification of a large number of corrupt industry insiders, but also prevented further fraudulent mortgages. Seven plea agreements have been signed to date; the investigation is ongoing.

Fraud Trends:

Although there are many mortgage fraud schemes, the FBI is focusing its efforts on those perpetrated by industry insiders. The FBI is engaged with the mortgage industry in identifying fraud trends and educating the public. Some of the current rising mortgage fraud trends include: equity skimming, property flipping and mortgage identity related theft. Equity skimming is a tried and true method of committing mortgage fraud and criminals continue to devise new schemes. Today's common equity skimming schemes involve the use of corporate shell companies, corporate identity theft and the use or threat of bankruptcy/foreclosure to dupe homeowners and investors. Property flipping is nothing new; however, once again law enforcement is faced with an educated criminal element that is using identity theft, straw borrowers and shell companies, along with industry insiders to conceal their methods and override lender controls. It should also be noted that identity theft in its many forms is a growing problem and is manifested in many ways, including mortgage documents. The mortgage industry has indicated that personal, corporate and professional identity theft in the mortgage industry is on the rise. Computer technology advances and the use of online sources have also assisted the criminal in committing mortgage fraud. However, the FBI and its law enforcement and industry partners are working together to identify trends and develop techniques to thwart illegal activities in this arena.

Law Enforcement Partnerships:

In 1999, the FBI joined forces with HUD-OIG to establish the Housing Fraud Initiative (HFI) Task Force. As a result, numerous successful joint investigations were conducted in New

York, Baltimore, Washington D.C., Chicago, Los Angeles, and Dallas. The FBI is actively investigating mortgage fraud in those cities and continues to promote joint investigations with HUD-OIG and other federal, state and local law enforcement and regulatory agencies wherever mortgage fraud is prevalent.

With regard to the HFI initiative the following serve as examples of successful joint investigations:

A two-year joint investigation by the FBI , the IRS, and HUD-OIG revealed a fraud for profit scheme committed by several insiders of First Beneficial Mortgage Corporation. This two year fraud was perpetrated against Fannie Mae and Ginnie Mae home loan programs resulting in losses exceeding $30 million. Recently, the president of First Beneficial Mortgage Corporation and six others were convicted on conspiracy, bank fraud, wire fraud, and money laundering charges. The president was sentenced to 21 years in prison, ordered to pay $23 million in restitution and forfeited about $8 million in property.

A joint investigation conducted by the Los Angeles FBI Office and HUD-OIG illustrated an extensive scheme in which fraudulent identification and employment documents were used to perpetrate mortgage frauds. The scheme was largely assisted by an individual who regularly manufactured false identity and income documents for a profit. This document forger created W-2s, pay stubs, credit letters and social security printouts over an eight-year period. These documents were used by real estate professionals who knowingly submitted the falsified information to lending institutions. The loans were then insured by HUD and caused a loss to

that agency of more than $18 million. A search warrant executed during the investigation revealed more than 100 real estate professionals had ordered false documents in the past. To date, the document forger and six associates have been convicted in the scheme, as well as fourteen real estate professionals.

A two-year joint investigation conducted by the Kansas City FBI Office, IRS, and HUD-OIG culminated on August 13, 2004 with the arrest of a local real estate investor. The real estate investor and three business associates were charged in U.S. District court for their alleged roles in purchasing run-down properties, securing fraudulent appraisals and obtaining mortgages in the names of straw purchasers. The straw purchasers were allegedly paid $2,000 for their role in the scheme whereby they placed properties in foreclosure, leaving the real estate investor and his associates with the mortgage proceeds. This scenario was repeated approximately 300 times, resulting in losses to lending and financial institutions in excess of $15 million.

Industry Liaison:

The FBI focuses on fostering relationships and partnerships with the mortgage industry to promote mortgage fraud awareness. Over the past two years, the FBI has spoken at and participated in various mortgage industry conferences and seminars, including those sponsored by the MBA. This year the FBI will be speaking at and participating in the MBA's 91st Annual Convention and Expo. The MBA estimates that six thousand industry leaders will attend this conference.

To raise awareness of this issue and provide easy accessibility to investigative personnel, the FBI has provided contact information for all FBI Mortgage Fraud Supervisors to relevant groups including the MBA, Mortgage Asset Research Institute, Fannie Mae, Freddie Mac and others. Additionally, the FBI is collaborating with industry to develop a more efficient mortgage fraud reporting mechanism for those not mandated to report such activity. This Suspicious Mortgage Activity Report (SMARt Form) concept is under consideration by the MBA. The FBI supports providing a "safe harbor" for lending institutions, appraisers, brokers and other mortgage professionals similar to the provisions afforded to financial institutions providing SAR information. The "Safe Harbor" provision would provide necessary protections to the mortgage industry under a mandatory reporting mechanism. This will also better enable the FBI to provide reliable mortgage fraud information based on a more representative population in the mortgage industry.

A recent analysis of mortgage industry fraud surveys identified 26 different states as having significant mortgage fraud problems. Although every survey identified Georgia and Florida as having significant mortgage fraud related investigations, the survey also identified nine other states in the South and Southwest, seven states in the West and five states in the Midwest as having mortgage fraud problems. Once again, these studies illustrate the need for increased coordination among industry and law enforcement on mortgage fraud.

Lenders are increasingly aware that fraud is affecting their bottom line. Through routine interaction with FBI personnel, industry representatives are aware of our commitment to address this crime problem. The FBI frequently participates in industry sponsored fraud deterrence

seminars, conferences and meetings which include topics such as quality control and industry best practices to detect, stop and prevent mortgage fraud. These meetings play a significant role in training and educating industry professionals. Companies share current and common fraud trends, loan underwriting weaknesses and best practices for fraud avoidance. These meetings also increase the interaction between industry and FBI personnel.

Additionally, the FBI continues to train its personnel and conduct joint training with HUD-OIG and industry on mortgage fraud. As a training model, the FBI seeks industry experts to assist in its internal training programs. In this past year, industry has assisted training FBI personnel on mortgage industry practices, documentation, laws and regulations. Industry partners have offered to assist the FBI in developing advanced mortgage fraud investigative training material and fraud detection tools.

Conclusion:

In conclusion, the FBI is committed to increasing liaison and education efforts and partnering with federal, state, and local law enforcement, and private industry to combat mortgage fraud. The FBI supports new approaches to address mortgage fraud and its effects on the U.S. financial system, to include:

- a mechanism to require the mortgage industry to report fraudulent activity, and
- the creation of "Safe Harbor" provisions to protect the mortgage industry under a mandatory reporting mechanism.

Mr. Chairman, the FBI looks forward to working with you and other members of this committee on solving this problem. Thank you for allowing me the opportunity to testify before you today. I will be happy to entertain any questions you may have.

Testimony

before the

Subcommittee on Housing and Community Opportunity

at a Hearing regarding

"Mortgage Fraud and its Impact on Mortgage Lenders"

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Chairman Ney, Ms. Waters, and members of both subcommittees, thank you for the opportunity to address you on the important issue of subprime lending. My name is Lez Trujillo, and I am the national field director of the ACORN Housing Corporation. Previously, I was the west coast regional director for ACORN Housing from 2000 to 2004.

ACORN Housing has offices in 34 cities throughout the United States. To carry out our mission, we undertake three groups of activities:

1. We build and rehabilitate homes to increase the supply of affordable housing.

2. We provide housing counseling services to more individuals than any other organization in the country. 50,000 of our clients have become first time homebuyers. Our program emphasizes the one-on-one approach to counseling that has proven to be most effective at giving clients the information and tools they need. We counsel clients on the full range of housing finance needs: pre-purchase, delinquency, refinance, home equity, subprime, and predatory rescue.

3. We educate local, state, and national policy makers on affordable housing and housing finance issues, and on the threats to personal and community stability that are posed by predatory lending and abusive financial service practices

ACORN Housing works closely with our sister organization, ACORN, the Association of Community Organizations for Reform Now. With over 150,000 members in over 60 cities, ACORN has been a leader in the fight to end redlining through a strong Community Reinvestment Act (CRA), to crack down on predatory lending through testimony, publicity, and direct action, and to win economic justice for our communities. ACORN fights to win a voice for our families to improve education, increase access to health care, and assure fair housing for all Americans.

Mortgage fraud is a nationwide problem. In recent weeks, much of the attention has been about how lenders are hurt by this form of fraud, but it is even more important to look at the people all over the country who have been taken advantage of. While it hurts the bottom line of financial institutions when they are taken advantage of, it devastates the lives of citizens when they are victimized by these scams.

When we listen to the stories of victims, we learn that there is more than one element of the problem. Many scams are caused by outrageous local fraudulent operators, but others are dependent on the behaviors of large and often apparently respectable players in the industry. There needs to be national solutions to this crisis, but we must also maintain the ability of local authorities to react quickly to scams that arise. Just as important, we must remove incentives that lead to dangerous behavior on behalf of lenders and others in the industry, and we must give consumers the tools they need to spot those who are out to get them.

Let me begin by describing some of the cases we have come across from throughout the country.

The efforts of Senator Mikulski and others have brought attention to the problems of mortgage fraud in Baltimore. It is worth looking at one of these cases again, because although great progress has been made in cracking down on some of the abuses there, we see these same practices emerging in other cities.

American Skycorp abused the FHA program to extend loans on homes with inflated values and unmet promises of future repairs. These loans were generally made without regard of the borrower's ability to repay. One family with an income of $13,000 were loaned $77,000 for a house. A loan like that is virtually impossible to repay. These loans targeted African-Americans, who received 77% of the company's loans. An investigation by the Maryland Attorney General's office found that the company "sold homes at inflated prices, using falsified appraisals" and "falsified documents to provide first-time homebuyers with mortgages they could not afford and [the company] then sold the mortgages." The Attorney General's office said, "Not only do have these practices adversely affected individual consumers, they have created significant problems for the neighborhoods in which these consumers live...When the consumers default and the property is foreclosed upon, the practice hurts the neighborhood in which the consumer lives."[1]

In 1998, Matilda Watson, a participant in the welfare-to-work program, bought a house with American Skycorp. The loan officer falsified information on her application to get the loan approved, insisting Matilda include child support payments even though she was not receiving them. Matilda thought $54,000 sounded high for a house in that neighborhood, but her realtor insisted that a FHA lender would not approve a loan if the house wasn't worth it. When she later asked about a home inspection, she was assured that the lender would make sure the house was in good shape.

Although the house seemed fine on the surface, as soon as Matilda closed on the loan, she found out the house was falling apart. The furnace stopped working, the upstairs plumbing leaked into the kitchen, and the wiring was faulty. The appraiser noted none of these problems.

Most tragically for Matilda and her family, the Department of Social Services deemed the house unfit for her children to live in, and they removed her children from the home.

When ACORN brought these problems to light, they were sued for $10 million by Skycorp for defamation of character. The suit was quietly dropped when the federal government successfully prosecuted the company for precisely the same practices ACORN had accused them of.

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[1] John B. O'Donnell "4 Accused of Flipping Must Pay Purchasers; Men Ordered to Cover Cost of Probe, Prosecution," *The Baltimore Sun,* Saturday, October 26, 2002.

Another example of mortgage fraud that has received a great deal of attention lately is in the Poconos. There are documented cases of over 3500 defaults and foreclosures in this one small area in northeast Pennsylvania. As the *New York Times* has reported, there was a huge development initiative by several developers that provided a one-stop-shop for the following: development (they had purchased the land and controlled the development process), contractor work (done by the same people as the development or they controlled the construction), legal work and appraisals related to the transaction and mortgage brokerage services

In a typical one stop shop there are no checks and balances by outside parties, and in Pennsylvania, no borrower attorney is required, so borrowers were on their own. Nobody was watching, not the state, not the banks and the results were catastrophic for the homebuyers, who are mostly working-class Latinos and African-Americans from New York City, looking for affordable housing.

The developers that began the development projects "set the market:" that is, they set the appraised value. "Comps" used by appraisers were based on the other houses they had built, not anything that was out there already, since these were all new development going up at approximately the same time

The developers were, or were related to, the contractors, and construction was flawed in many instances

The result was that properties were over appraised. The market was set artificially and set far too high. When residents had job loss, family crisis or necessary repairs (due to shoddy construction), they were in real trouble. The houses had the maximum loan to value ratio or they exceeded loan to value, so there was no way to refinance or pull any equity from the house to tide the residents over. They were just out of luck, and defaults and subsequent foreclosures followed.

Only when record numbers of foreclosures were documented did the Pennsylvania Banking Department begin to pay attention. There is a plan of action but there really is no remedy or recourse by borrowers for the faulty pretenses, over appraisal, and shoddy construction. Once again, ordinary people pay the price for mortgage fraud.

In Albuquerque, New Mexico, residents of Rio Bravo Estates, a new development, found out about the project when shopping for manufactured homes. They were steered to the development where a businessman arranged for their land purchases and verbally promised such things as a park and a perimeter fence. One of the agents for the land development company is also on the Board of Directors of Valley National Bank, the bank financing the land purchases.

The land was overpriced – for a quarter of an acre in the South Valley, a block away from the Sewage treatment plant (a fact that was not disclosed) people paid from $30,000 to $55,000. Evidence has emerged that this property was tremendously overpriced. The "full land value" listed on one resident's taxes is $7,000. An appraiser friend of another

resident suggested the maximum value for the land would be $14,000. The real estate contracts with Valley National Bank for the land were set up with 8% interest rates that would adjust to 12% after a year. Most of the residents knew that this would happen and were told they would have help refinancing. This arrangement meant that Valley National would get their money after a year, and could then get out.

It would be difficult to find a legitimate bank to refinance loans that were so much more than the actual value of the property. For example, one home was financed for $140,000, while a recent CMA puts its value at the low-to-middle 80s. A woman who residents identified as working for the businessman who put the deal together, helped most people refinance, but she referred them to sub prime lenders, regardless of their credit history. Almost without exception the appraisals were done by one company, even though they were financed with different mortgage companies. Further, the copies of the appraisals show that the appraiser was from far away, and may not have been aware of (or may be able to claim that he wasn't aware of) the sewage treatment plant.

The ultimate result of this is that people paid well over twice what they should have on their land, and were financed through loans with predatory terms they were not aware of, and which they could not afford, regardless of their personal credit history or ability to pay. Only a predatory lender would be willing to look the other way and finance property for more than its value. These loans also had other common predatory characteristics. One woman was refinanced one day after buying the home, and worked with the same individuals on both loans. She was still sold $4,000 in points and $6,000 in insurance on the first loan, which would be invalid when she refinanced the next day. Further, at least two residents are carrying $10,000 notes with the responsible bank, above and beyond their refinanced mortgages. They were unaware of these notes when they signed their paperwork, and in one instance a woman was told before closing not to mention it to the title company.

Residents report many code violations including homes built too close to the railroad tracks, electrical wiring which was jerry rigged off of other lines, foundations which were not allowed to cure, concrete which was not reinforced and which was not poured as thick as is required. When residents complained to the local Manufactured Housing Committee, they found that the businessman who set up this deal had been appointed as the head of the committee! This despite the fact that he had run several manufactured housing sales corporations where his license had been revoked.

Some residents ended up paying about $1,500 a month, far more than they could afford, and about one third of the residents lost their homes. Many are FHA homes, so the taxpayers ended up footing the bill.

While the responsibility for this fraud has been distributed, the victims bear the full brunt of its consequences. Many have had their credit ruined trying to keep up with predatory loans, others have lost their homes, all have watched their neighborhood deteriorate before their eyes.

Another scam we have come across is the practice of "contract-for deed," which has been called "nothing less than modern day sharecropping." We first came across this practice in Houston.

Houston ACORN has worked with a group of low income home buyers who have all purchased houses using a "Contract For Deed" from a developer named Jack Markman or one of his associates. All of the homebuyers are Spanish speaking immigrants. They all conversed with Spanish speaking representatives of one of the Markman companies, and then signed contracts in English which they did not understand. In general the buyers did not understand the main problem with the contract: the fact that they would have to complete the entire contract before they would be owners of the house. In many cases there are no legal descriptions or maps with the contracts.

According to the Texas Secretary of State, Jack Markman is affiliated with nineteen different development companies. The homebuyers have purchased their homes from one of four of his companies: St. Mary's Construction, Markman and Martinez Investments, Markman and Humphries Investments, or Markman Bros. Investments. It appears Markman or on of his companies own over 800 pieces of property in Houston, and some of the properties have as many as 40 houses on them. We understand that the houses are typically bought on auction, and sold to families who are willing to fix them up. According to ACORN's research, it appears that most of the property is not properly platted nor subdivided. Most of the properties are also not registered with the Harris County Appraisal District with individual tax accounts for the homebuyers.

Markman requires people to pay anywhere from $300 to $5000 as a down payment to get the house. All of them were told that after they paid the down payment they would do the "closing." All of the contracts have an interest rate between 10% to 11%. Most residents pay between $250 to $500 a month.

While there are numerous concerns about the transaction, the most common concern brought by the families relates to their increasing monthly payments. Markman attributes the increases in monthly payments to rising taxes and insurance that has created a delinquent escrow account that people need to catch up on. This was impossible for residents to confirm. When buyers have gone to Harris County Appraisal District to request to see their property's tax bill, most have been told that their property is not registered as an individual property with the county. In most cases the property is part of a larger tract of land, which is being taxed as either one house on a large piece of land or one large lot. Since the property does not have an individual tax account it is difficult to decipher if the rising escrow cost is truly attributed to their rising taxes or if Markman is arbitrarily charging money to the buyer's escrow accounts.

Buyers are also paying for insurance with their escrow account. The insurance appears to have a $5,000 deductible, and company's offices are based out of the Turks & Caicos Islands and does not have a license to operate in Texas. One homebuyer's house burned down not long ago and she was never able to get money from the policy.

Many residents have moved out because they were intimidated by the company or frustrated and confused by the situation. Once buyers realize that their individual properties are not on the tax roles nor are they platted or registered, often they decide to cut their losses and move out of their house. Markman has sold these houses time and time again after buyers move out and he has kept the down payments. Some residents have been intimidated into leaving. For example, one buyer was charged $2,300 all at once for what they were told were delinquent taxes and insurance costs. She could not pay and she left out of fear that she would be forcibly removed.

In a few cases Markman has sold an entire group of houses, between 20 and 45 at a time, to a third party, small time investor. The third party is usually looking to convert the houses into rental units as an investment. Through other forms of intimidation the third party has forced many families out of the houses, or tricked them into converting their contracts into rental lease agreements.

Residents are not taking this lying down. Over 140 families who have bought houses from Markman or one of his associated companies on a "contract for deed" basis are organizing to obtain the clear title from Markman to their home. Most have joined ACORN and they meet regularly. They have elected leadership from among the group to mobilize the families as needed, and to develop organizing strategies to address the problem.

Since mid-January, 2003 these residents have been taking a variety of actions to address their concerns. After a demonstration at Markman's office on Friday January 30th a negotiating committee of the homebuyers met with Markman and his associates. Markman refused much of their demands but he did clarify in a written statement that he would accept prepayments, without penalty, on the contracts. He claimed that this has always been his policy, regardless of the fact that the contracts clearly state, "no prepayments may be made," and regardless of the fact that a number of people tried to pay out and were refused. Of course, since the houses do not seem to be registered nor platted, it is difficult for the families to get traditional financing from a lender to pay off the contract.

On Wednesday March 3rd, sixty seven homebuyers filed their contracts with the Harris County Real Property Division so that the purchasers' names are now on record as having an interest in buying the properties. This was done to prevent third party investors from buying from Markman without recognizing those who have been paying on the properties for the last seven to fifteen years. We also hope it will enable the homebuyers to set up their own tax accounts in their names and qualify for a variety of homestead exemptions.

Markman has violated the law in a variety of ways, which should give these homebuyers leverage to get Markman to convert their contracts to warranty deeds and notes/deeds of trust. Litigation will likely be needed to bring him to the table, judging by his entrenched policies and statements made to the homebuyers thus far. Those that have moved want proper compensation for their years of investment in their homes.

The overall goal of the homebuyers is to obtain good, marketable title to the homes they have been paying for. They also want an agreement that Markman will change his business practices and stop preying on low income and minority homebuyers. In the long term, ACORN members want to pass both local and state policies to tighten up the law to provide protections for homebuyers and to prohibit real estate investors like Markman and others from offering abusive "contract for deed" scams.

There are many contributing factors to the problem of mortgage fraud, but here are a few. Low documentation or no documentation loans make fraud far easier. Another contributing factor is the lack of alternatives to these shoddy operators; reputable lenders making good loans at good rates would help drive these criminals from the market.

But perhaps the most important reason for the explosion in these predatory factors is that the volume-driven, securitization-based market gives incentives to be reckless. Because too many market participants—from lenders to brokers to appraisers—make money up-front, with little financial incentive to ensure that their actions do not harm consumers, there is an incentive to take actions that harm borrowers—and often other market participants—down the road.

This is especially apparent in the subprime market, where business is done without lawyers and other protections. Because so much money is made up front in the form of points and fees—and in the form of yield spread premiums to brokers--there is less incentive to ensure that the loans perform. There is also less access to legal recourse because of the prevalence of mandatory arbitration clauses.

Unfortunately it is not just fly-by-night operators who have been involved in these scams. For example, there have been reports of repeated and major appraisal problems from big lenders, as well, with lenders accused of pressuring appraisers to come up with appraisals that justify their loans. The American Banker reported on a recent case in Iowa that involved the Des Moines mortgage unit of Wells Fargo & Co.

The appraiser "had a long-standing relationship with Brenton Bank, a Des Moines lender that merged with Wells in 2001. He said the Benton loan officers he had dealt with in the past stayed at Wells, but when their compensation shifted to commissions from salaries, they became more aggressive in their demands for higher appraisals. When his shop refused to play along, 'we saw a real slowdown in orders, and they stopped altogether for two-month periods,' and Wells was slow to pay for appraisals on loans that did not close."[2] The volume-driven market here is providing incentives that harm consumers.

Who do these scams effect?

Our experience, as reflected in the cases above, is that these scams target the most vulnerable, often low- or moderate-income people, many elderly, and often immigrants.

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[2] Erick Berquist, "A View of the Refi Boom From the Appraisal Trenches," *American Banker*, Thursday, February 5, 2004.

In addition, low-income homebuyers and people of color are much more likely to be in the subprime market, where much of these practices occur. Our reports "The Great Divide" and "Separate and Unequal", available on our website, document the large percentage of subprime loans that go to these borrowers.

Vulnerable borrowers in the subprime market are in effect punished twice—they pay more for risk, and then if things go wrong, as in cases above, they face the consequences

Let us now briefly examine what can be done to solve these problems.

We need both national protections against predatory practices and state and local action against predators. It is states' ability to respond quickly to problems—whether they be in inner-city Baltimore or rural Pennsylvania—that makes it vitally important that federal action not preempt their ability to protect their citizens. This is why we oppose the Office of the Comptroller of the Currency's preemption of state laws as they affect national banks.

We must make sure that the bad actors are held responsible for their actions. The entire chain of actors involved in these transactions has a responsibility to help solve the problem, from lenders, to mortgage brokers, to appraisers and real estate agents.

This chain also includes consumers themselves, which is why we are so involved in housing counseling. Counseling helps ensure that borrowers can spot bad actors, and it helps connect borrowers with reputable market participants. We think adequate funding of housing counseling is very important.

Responsibility also means more resources for enforcement to help crack down on the scam artists.

It means appraisal reform, so that appraisers are not pressured to give false appraisals.

Finally, it means a strong Community Reinvestment Act, so that responsible financial institutions have an incentive to lend in underserved communities, and so that those institutions that participate in predatory practices are punished with lower ratings. We believe that the FDIC's action in exempting many banks from the stronger large institution test is wrong, and should be reversed.

Mortgage fraud is a complicated and troubling issue. While it causes heartache for banks and other lenders as they look at their bottom line, it causes far worse anguish for many of the families we represent. We hear their stories, and we believe strongly their experiences must be part of the debate in how to end mortgage fraud. Thank you for the opportunity to address you today and I am happy to answer any questions you may have today.

Statement of

Assistant Secretary John C. Weicher

for the hearing titled

"Impact of Mortgage Fraud"

Before the

House Subcommittee on Housing and
Community Opportunity

U.S. House of Representatives

October 7, 2004

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Good morning Chairman Ney, Ranking Member Waters, and distinguished Members of the Subcommittee on Housing and Community Opportunity. On behalf of Secretary Jackson and the Department, thank you for this opportunity to testify on mortgage fraud and its impact. Mortgage fraud and predatory practices adversely affect both homebuyers and the real estate finance industry. Inevitably the costs resulting from the actions of a small number of disreputable individuals are borne in part by homebuyers and mortgage lenders, as well as by taxpayers. Today I would like to provide you with an overview of HUD's initiatives and describe what HUD, particularly the Federal Housing Administration (FHA), is currently doing to address this problem.

Predatory practices can take many forms, from making a mortgage loan to an individual who does not have the ability to pay, to property flipping. Lenders who use these tactics often target our most vulnerable populations. First time homebuyers in particular are not familiar with the mortgage origination process. Susceptible borrowers are steered toward over-priced service providers or encounter high-pressure salespeople.

One common predatory practice is to impose on a borrower excessive fees and points, with the promise that the borrower can refinance to a lower rate a few months after origination. The end result is that the borrower pays origination fees twice, in order to obtain mortgage terms they should have received with their initial mortgage loan.

Predatory loans harm borrowers by making it difficult or impossible for them to keep up with payments. If they miss their payments, they risk losing their home, their credit standing and their initial investment. Even if they remain current in their mortgage, a homebuyer may owe more than their home is worth, making resale of their home impossible.

Predatory lending can rise to the level of criminal activity and constitute mortgage fraud. Mortgage fraud is a criminal activity, knowingly undertaken by individuals intent on profiting at the expense of others. Actions include deliberate manipulation of property valuations; falsification of borrower financial information; forgery of licenses; certifications and titles; and misrepresentation of property ownership and conditions.

Fraud is often only discovered when the borrower defaults on the mortgage, and the lender, investor, or insurer – such as FHA -performs a quality control review on the loan. By statute, FHA refers all potential fraud to HUD's Office of Inspector General (OIG).

FHA has the authority to monitor lenders for program compliance. During the last four years, FHA has completed 3,623 lender monitoring reviews. As a result, FHA made 1,345 referrals to the OIG to investigate findings of possible fraud during this period.

Borrowers are not the only victims of mortgage fraud and predatory practices. Within the FHA mortgage insurance program, lenders are financially liable for the portion of the costs associated with delinquency and foreclosure that HUD will not reimburse (usually higher-than-

customary servicing expenses and a portion of the foreclosure costs). Lenders whose employees violate FHA guidelines may also be required to indemnify loans (thereby reimbursing HUD for all losses associated with the loan) if the lender failed to use proper, early due diligence and effective control measures to detect fraud associated with a loan. In addition, a lender's FHA default and claim rate calculated by HUD will be negatively impacted due to fraudulent loans, which could affect the lender's ability to continue to do business with FHA as an FHA approved lender. Lenders who purchase fraudulently originated loans from other lenders may incur significant costs as well. To avoid these risks, credible lenders must incur expenses to strengthen internal control processes.

Concern over lawsuits is certainly a motivational factor for lenders to aggressively address risk associated with mortgage fraud. Civil actions resulting from mortgage fraud can be expensive. The most effective approach for lenders to mitigate such risk is to demonstrate that effective internal controls and due diligence procedures are in place to detect fraud, that actions are swiftly taken to terminate relationships with the perpetrators, and to ensure that the victims of fraud are appropriately compensated.

FHA's actions to combat mortgage fraud and predatory practices

FHA has made significant efforts through consumer education, enforcement actions and regulatory reforms to combat abusive and deceptive practices. Before I discuss the full range of these efforts across all FHA's insurance programs, I would like to describe FHA's mortgage insurance activity to the Subcommittee, in order to place our efforts in context. FHA insures mortgages for homebuyers who may not qualify for conventional mortgage loans. Our typical borrower is a young, first-time homebuyer, often a minority household. For the first 11 months of FY 2004, FHA insured 578,774 home purchase mortgages. Of these, 72 percent were to first-time homebuyers; 33 percent of those were to minority first-time homebuyers. FHA has 15 percent of the home market share, but 27 percent of the market for low-income homebuyers.

HUD believes that our first line of protection is an informed consumer. Housing counseling has proven to be an extremely important activity to educate consumers on how to avoid abusive practices. Housing counseling agencies help educate borrowers, so they have the financial literacy they need to protect themselves. Counselors assist individuals with making intelligent decisions, helping unwary borrowers avoid inflated appraisals, unreasonably high interest rates, unaffordable repayment terms, and other conditions that can result in a loss of equity, increased debt, default, and even foreclosure.

In FY 2004, HUD awarded $36 million in grants to HUD-approved housing counseling agencies. Based on actual activity and outcomes from past years, HUD projects these grants will assist more than 700,000 people to either become first-time homeowners, or remain homeowners after their purchase. The grants were awarded to 19 national and regional organizations and 342 state and local housing counseling agencies. Additionally, HUD will award $7.75 million to standardize and improve the quality of counseling provided by HUD-approved housing counseling agencies.

We know that housing counseling works. Families who receive counseling are better able to select the best mortgage for their needs and better able to manage their finances so they can remain

in their homes. Housing counselors help to heighten the awareness of potential homeowners of the dangers of mortgage fraud and predatory practices.

FHA is improving the way citizens find HUD approved housing counseling agencies. Currently, in order to find a local HUD approved housing counseling agency, an individual calls a toll free number and interacts with an automated computer system. By the end of fiscal year 2005, the computer will be replaced by live operators.

Final Rules

The Department has developed new requirements specifically targeting predatory practices to protect all FHA borrowers and set an example for the rest of the housing industry. In particular, there are several new, more stringent procedures for participating in FHA insured programs that have been implemented in eight Final Rules. They include:

- A Lender Accountability Rule that clearly establishes lender responsibilities associated with the quality of property appraisals, effective August 19, 2004.
- A Rule establishing a Fee Panel Inspector Roster. This Rule provides criteria for placement of new construction home inspectors on the roster and established procedures for removal from the roster. This rule became effective April 9, 2004.
- An Anti-Flipping Rule prohibiting FHA insurance on a property resold within 90 days of the previous sale, and also prohibiting sale of a property by anyone other than the owner of record. This rule became effective in June 2003.
- An Appraiser Qualifications Rule for Placement on FHA Single Family Appraiser Roster, establishing stronger professional credentials for FHA-approved appraisers. This rule became effective in June 2003.
- A rule for HUD's roster of 203(k) consultants, to ensure the consultants meet HUD requirements. This rule became effective in September 2002.
- A rule allowing Electronic Submission of Audited Financial Statements. This rule enables HUD to identify and remove noncompliant lenders more quickly. This rule became effective in September 2002.
- A rule establishing Placement and Removal Procedures for HUD's Nonprofit Organization Roster, better insuring that nonprofits participating in FHA programs meet HUD requirements. This rule became effective in July 2002.
- An Interim rule that ensure that seniors who refinanced their FHA insure reverse equity mortgage were not subjected to mortgage churning by the lender. Mortgage churning benefits the lender by refinancing the original mortgage with no benefit to the borrower. This rule became effective in April 2004.

Proposed rules:

- A proposed rule limiting nonprofit organization participation in FHA Single Family activities. This rule proposes ways to reduce defaults by nonprofits and create more reasonable conditions for ensuring qualified nonprofit participation in FHA programs. It would limit nonprofits to ownership of 10 FHA insured loans at one time, restricts nonprofits to single unit properties, and requires the nonprofit to have its 501 (c3) status for two years. This proposed rule was published April 2004.

- A proposed rule revising FHA's Credit Watch program to capture underwriting lenders as well as originators, and preventing a lender from opening a new branch within the area covered by the proposed termination. This proposed rule was published in April 2003.

- A proposed rule published on April 14, 2004, which would establish a procedure for HUD to impose new penalties on lenders that fail to engage in loss mitigation. These penalties would amount to three times the amount of a foreclosure claim submitted by a lender on a foreclosure claim. This powerful sanction will be applied to any lender who consistently falls in the on the bottom tier of FHA's "Tier Ranking System" for servicing lenders, and where specific failure to engage in loss mitigation prior to foreclosure is detected.

Program Improvements:

FHA has also put in place a series of policy directives designed to elevate industry standards for deterring mortgage fraud and predatory lending while also protecting the Government from incurring excessive risk. These include:

- Deployment of the "TOTAL Scorecard", an automated risk scoring algorithm that interfaces with an automated underwriting system. TOTAL allows FHA to better gauge risk, particularly among marginally qualified borrowers, and helps FHA to understand and manage credit risk of mortgages entering its portfolio. With the TOTAL Scorecard, FHA can expand the scope of borrower participation while more precisely managing risk.

- Update of FHA's Mortgage Credit Underwriting Handbook, which clarified and strengthened those policy areas that may have previously been open to varying interpretations by lenders.

- Issuance of new guidance related to new construction transactions. Most particularly, FHA requirements were tightened to address a predatory practice of underwriting a mortgage based upon tax assessments for an unimproved property. Lenders must now ensure that borrower income and escrows will support tax requirements for the *improved* property on new construction financing. This same guidance established tighter underwriting requirements for "mortgage buy-downs", an approach often abused by predatory lenders in order to improperly qualify borrowers for loans the borrowers cannot afford.

- Issuance of new guidance on Social Security Number verification. This initiative reduces the likelihood that a borrower on a FHA mortgage is using a false social security number or otherwise committing identity theft and fraud in connection with obtaining an FHA-insured mortgage.

- Implementation of an automated risk-based assessment, following mortgage insurance endorsement, to improve FHA's ability to identify, monitor and oversee loan compliance.

- Implementation of Appraiser Watch, a risk based monitoring of appraisers. This change resulted in a higher number of appraisers being removed from the FHA Appraiser Roster, because they prepared appraisals that did not meet FHA's requirements.

- In Fiscal Year 2004, FHA established a national training program for lenders and appraisers. Over 1,000 lenders have participated in this training program. This training provided comprehensive information in participating in FHA single-family mortgage programs.

Monitoring and Enforcement

In addition to establishing more stringent procedures for participating in FHA insured programs, the Department is taking aggressive action concerning business partners that demonstrate poor performance and abusive practices.

FHA has created the Credit Watch Program, which tracks quarterly the default rates for the 25,000 lender offices that originate FHA loans, and enables HUD to terminate those lender branches where the default rate significantly exceeds that of the local jurisdiction. Credit Watch protects the integrity of the FHA insurance funds and sanctions those lenders who demonstrate imprudent or possible abusive lending practices. The default rates of these lenders are published on the Web and thereby serve as a source of information by which other lenders and interested parties can judge a lender's performance. Originally FHA set the standard for a "high default rate" at three times the rate for the local market. Subsequently, FHA issued Mortgagee Letter 2002-20 in September 2002, starting the process of gradually lowering that standard over a year. Since September 2003, FHA terminates lenders with early default rates exceeding twice the local market rate, unless there is a good explanation.

Since Credit Watch started in May 1999, FHA has terminated 261 lender branches and currently have another 14 branches under review. The industry supports Credit Watch: we sanction the worst performers, and create a level playing field for those who follow the rules.

FHA also produces Neighborhood Watch, a web-based software application, for HUD oversight of lenders and lender self-monitoring. Neighborhood Watch compliments the Credit Watch Termination initiative by providing FHA approved lenders with statistical views of their performance. As a self-policing tool it has enabled lenders to monitor their performance in comparison to other lenders, to take corrective actions within their own organizations, and/or to sever relationships with poorly-performing business partners. Neighborhood Watch is also used by

community groups to monitor local lenders, and by HUD's OIG to identify possible lenders for audit or investigation. Neighborhood Watch is available at: https://entp.hud.gov/sfnw/public/.

When FHA staff finds evidence of widespread abuse of HUD's program requirements, lenders are referred to the Mortgagee Review Board (MRB) for action. I chair the MRB and other senior HUD officials serve on the Board. Board cases generally involve only the most serious findings. The MRB is authorized to impose a range of administrative sanctions from a letter of reprimand to withdrawal of a Mortgagee's FHA approval. The MRB may also impose civil money penalties. FHA monitors the activities of lenders down to the branch level. Based on these reviews, over the past four years, the MRB took action against 174 lenders, withdrew FHA approval of 44 of them, and assessed $8.83 million in civil money penalties. Also, 11,419 loan indemnification agreements were executed for a potential total savings of about $266 million. When FHA finds loans that are improperly originated or underwritten, we require indemnification: if the loan defaults, the lender pays, not the FHA Mutual Mortgage Insurance Fund. FHA made over 1,345 referrals to the OIG for further investigations. FHA has proposed debarment of 1,995 individuals and entities from participating in FHA's Single-Family Programs.

Appraiser Watch

As I previously noted, FHA has also created a new risk management tool to target appraisers for review, known as "Appraiser Watch." Appraiser Watch uses traditional risk factors - such as loan volume, loan performance, and loan type - to compare appraisers across peer groups and identify appraisers for review. With Appraiser Watch, FHA can better identify appraisers who either knowingly or unintentionally put homeowners at risk of losing their homes to foreclosure because of inflated valuations and sometimes the poor condition of the property.

Appraiser Watch is a major improvement over the appraiser monitoring system we inherited from the previous administration. Under the previous appraiser monitoring methodology, used from 1999-2001, 30,000 appraisals were field reviewed through contract at a cost of $46 million, yet only 33 appraisers were removed from the FHA Appraiser Roster.

In FY 2002, when FHA began testing a new risk-based targeting methodology, which ultimately led to the creation of Appraiser Watch, directed by FHA, a smaller number of higher risk appraisals, 1,868 appraisals (representing 708 appraisers) were field reviewed at a cost of $300,000 and 97 appraisers were removed from the FHA Appraiser Roster.

In FY 2003, under the Appraiser Watch methodology, 1,420 appraisals (representing 767 appraisers) were field reviewed and 132 appraisers were removed from the FHA Appraiser Roster at a cost of approximately $311,000.

For the first 3 quarters of FY 2004, 1,072 appraisals were field reviewed (representing 340 appraisers), and 96 appraisers were removed, at a cost of approximately $245,000.

These removals represent less than 1 percent of the total number of appraisers on the FHA Roster, but we have the industry's attention that we're serious about monitoring appraisals closely.

Inter-Agency Cooperation

HUD works closely with state and local governments to carry out enforcement actions against business partners engaged in predatory practices. On a national level, HUD's OIG continues to work closely with law enforcement in many states, notably in New York, New Jersey, Pennsylvania, Illinois and Arizona, to target unscrupulous lenders and better combat abusive lending practices. In many areas HUD is working with coalitions of community groups to provide relief to FHA insured borrowers who have been victimized by predatory practices.

HUD also works closely with the Department of Justice, federal financial regulators and the Federal Trade Commission to distinguish between predatory practices of some lenders and others whose practices are fairly serving the mortgage credit needs of those not qualified for prime loans.

Public Awareness

FHA is committed to increasing awareness in the public about predatory practices. FHA has developed literature about predatory lending and distributes this information at homeownership fairs and other public forums. HUD's website also includes information on the subject. Our website was just recently enhanced to allow easier access to this information to the general public. A link on HUD's primary page (www.hud.gov), named "Avoid Predatory Lenders" takes you to a page on "Predatory Lending," which contains information on how to recognize predatory lending and what to do about it. This page also contains links to additional information for each state, prepared by local organizations to address the problems most prevalent in their areas. I recently was interviewed on CNN regarding predatory practices, and among other indicators of public interest in this subject, hits on our web page soared the following day.

In addition, HUD has partnered with other organizations in public education campaigns about predatory lending. In early 2005, HUD will launch a national advertising campaign to warn against the dangers of predatory practices. The $1 million campaign consists of print, radio, and television ads. The ads are being produced under a contract with the National Fair Housing Alliance and the Ad Council.

HUD is also a member of the Interagency Task Force on Fair Lending. HUD worked with the task force in drafting a new brochure that alerts consumers to potential borrower pitfalls, including high cost loans and provides tips for getting the best financial deal possible.

Through HUD-sponsored Homeownership Fairs, participation in community events, and industry-sponsored forums, the Department is shining a bright light on unsavory mortgage lending practices.

Loss Mitigation

FHA also addresses predatory practices through our Loss Mitigation Program, which is often able to help a victim of such practices who has defaulted on an FHA-insured mortgage and faces possible foreclosure. Under this program, lenders have options that may help homeowners stay in their homes or may mitigate the financial consequences of the default if the homeowner does not have the resources to make that possible. FHA pays loss mitigation insurance claims to help qualified borrowers reinstate their mortgage. FHA regulations require that lenders explore all

available loss mitigation options prior to proceeding to foreclosure. The success of this program is clear. In Fiscal Year 2004, HUD helped more than 80,000 families avoid foreclosure, and the number of loss mitigation cases resolved by the borrower retaining their home through loss mitigation exceeded the number of cases resolved through foreclosure. In addition to helping these borrowers, the Department saved more than $1 billion in foreclosure claim expenses. As mentioned above, the Department is strengthening the enforcement of this requirement by imposing treble damages against lenders that fail to offer loss mitigation opportunities as appropriate.

Conclusion

I hope this discussion of our efforts and accomplishments has made clear that the Administration and the Department are aggressively policing its participants and imposing significant sanctions on business partners found to be violating procedures or otherwise engaged in abusive or deceptive behavior. In doing do, HUD is establishing standards and industry approaches that we hope will be adopted in the conventional market as well. The most effective means to reduce the adverse impact of predatory practices and mortgage fraud is to root out the culprits, and create an environment in the mortgage industry which fosters integrity and concern for the homebuyer. The Administration and the Department remain firmly committed to protecting consumers and all program participants against predatory practices and mortgage fraud.

This concludes my statement, Mr. Chairman. I thank the Committee for the opportunity to meet with you today to discuss this important issue.

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

COMMITTEE ON FINANCIAL SERVICES UNITED STATES HOUSE OF REPRESENTATIVES

"Mortgage Fraud and its Impact on Mortgage Lenders"

October 7, 2004

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its written testimony concerning mortgage fraud and its effect on mortgage lenders to the House Subcommittee on Housing and Community Opportunity. We commend the Subcommittee for investigating this scourge on our industry. The CMC was formed, in large part, to pursue reform of the mortgage origination process. The streamlining that the CMC has consistently championed would not only mean that consumers would be better informed when making credit choices, leading to the reduction of transaction costs and helping prevent abusive origination practices. It would also make more feasible the detection and elimination of all fraudulent practices from the mortgage process. This second goal is of critical importance to the CMC and its members. Mortgage fraud harms everyone, but it particularly harms lenders and servicers.

What is Mortgage Fraud and Why Is It Increasing

From 2000 through mid-2004, the FBI reported more than 11,000 convictions resulting from its investigations of financial fraud. As the FBI has noted recently, the incidence of mortgage fraud as a component of this number is increasing. With the mortgage industry originating trillions of dollars in loans each year, mortgage fraud committed on just a small fraction of this loan production can lead to staggering losses for the lending industry.

It has been said that mortgage fraud perpetrators are the terrorists of the mortgage industry. They look for a hole in the real estate finance system -- a crooked appraiser, a flexible closing agent, a loan officer employee that turns a blind eye -- and exploit it until the well runs dry or they go to jail.[1] In some cases, numerous participants are in on the scheme to dupe lenders out of millions of dollars. Other times, one individual instigates the fraud, playing on the naiveté or inattentiveness of others.

Mortgage fraud takes many forms, but the most common types involve: falsifying the financial qualifications, employment and income of loan applicants; securing inflated appraisals to increase loan amounts; falsifying identities of applicants (identity fraud); structuring real estate transactions in which "straw buyers" having no actual interest in the properties pose as prospective purchasers with sufficient income and assets to qualify for mortgage loans; and using straw buyers to obtain loan on multiple "owner occupied" properties.

With the volumes of transactions that occur today, the systems and capacity of all the participants in the mortgage loan process are stretched. With each refinancing boom the industry experiences, lenders just try to catch their breath and keep up with the applications pouring in. It is a tailor made situation for someone trying to cheat the system and go unnoticed. On the other hand, when a refinancing boom ends, individual loan originators may be under pressure to produce more volume and be tempted to allow

[1] MortgageDaily.com

certain practices that they think may go unnoticed, even though it ultimately will hurt their lender employer.

The Internet and technology have also made it easier to perpetrate fraud. Computer hackers can steal identities of unsuspecting consumers, false websites can be created that give the appearance of legitimacy, desk-top publishing has allowed documents to be replicated and forged with greater precision and accuracy than ever before.

Lenders Are the Greatest Victims of Mortgage Fraud

This fraud harms innocent borrowers who are unwittingly drawn in to schemes, are unable to make their payments, and ultimately suffer foreclosure. It hurts neighborhoods where properties that have been the subject of mortgage fraud become abandoned. It also harms the nation as a whole because the cost of fraud is ultimately passed through to borrowers as higher costs for mortgages. But most particularly, lenders and servicers are the greatest victims of mortgage fraud.

Mortgage lenders and servicers bear the brunt of mortgage fraud. Whether they hold loans in their portfolio or sell them to investors on the secondary market, they will suffer losses when the default occurs due to fraud. As a general rule, lenders and servicers do not benefit from defaulted loans. Rather they lose money – often significant amounts.

Simply put, a lender whose loans that go into default represent more than a small proportion of its total loans will not long be in the lending business. And when those defaults result from inflated appraisals, phony documentation, fabricated prior sales, the involvement of straw parties, or other fraudulent practices, the lender/servicer always loses. They generally have to buy back fraudulent loans from the secondary market and try to recover what they can from the fraudulent parties.

Lenders also face criticism or sanctions for making loans that involved fraud from regulators and federal insurers under the theory that the fraud occurred on their watch. The Federal Housing Administration, for example, may sanction lenders and will withdraw their FHA insurance on fraudulent loans. Finally, even though they are the most direct victims of loan fraud, lenders are litigation targets and can be drawn into litigation where their loans involved elements of fraud, particularly if any employee or contractor acting on the lender's behalf committed fraud.

Lenders Are Taking Action

Realizing that they are the principal victims of mortgage fraud, the members of the CMC have been very active in efforts to detect and deter fraud in their loan making operations. Components of these fraud-prevention programs include the following:

- *Thorough Due Diligence of Business Partners*

One of the most important steps our lenders take to prevent fraud is to get to know and hold accountable the mortgage brokers, correspondents, and appraisers with whom they do business. A thorough process of approving these individual and entities, including checking references, verifying employee backgrounds, conducting financial reviews, helps to assure their legitimacy. It is also important to evaluate the fraud-prevention systems these entities have in place for themselves.

- *Use of "Ineligible Lists"*

One way to screen out past perpetrators of fraud is to use an "ineligibility list." One of our members, Household Mortgage Services (HMS), has developed and uses such a list, which contains individuals and companies that are unacceptable sources of loan originators or providers of services relating to loans purchased by HMS. Until issues are resolved to the satisfaction of HMS, HMS and its affiliates will not purchase any loan that a listed individual or company played a role in originating. In addition, the CMC has long advocated a nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations.

- *Training Staff to Recognize Fraud and Encourage/Reward Discovery*

Our members have studied past practices of mortgage fraud to learn what characteristics make up a fraudulent loan and what red flags should trigger greater scrutiny. Among the red flags that suggest a higher possibility of mortgage fraud are the following:

- Purchase transactions where no realtor is involved
- Credit reports with residence and/or job discrepancies
- Large seller concessions or loans where the seller pays all the closing costs
- Inconsistencies between job and/or income and the borrower's age
- Where the seller of the property is a business
- Where a large amount of cash is going to the seller
- Unusual payoffs on the HUD-1 settlement statement
- Where there is an early address change
- 1st or 2nd payment default
- Where the Welcome letter is returned

It is important to train staff in these and other characteristics of mortgage fraud. To provide the correct incentives, some lenders include fraud detection and deterrence as a component in their loan officers' or other employees' compensation plans.

- *Use Technology to Statistically Identify Common Fraud Characteristics*

As the increase in technology has led to greater incidence of mortgage fraud, lenders are also using technology to combat it. For example, HMS has developed a FRAUD

SCORECARD that identifies seven factors have been statistically identified as common fraud characteristics. The factors are: (i) FICO above a certain score, (ii) income above a certain threshold, (iii) original balance above a certain threshold, (iv) if the applicant is submitted by a single individual, rather than by joint applicants; (v) owner-occupied status; (vi) the lien status of the loan; and (vii) if it is a purchase transaction. Each of these characteristics has been assigned a weighting, based on its experienced predictive power. Characteristics with greater weighting are more predictive. Owner occupancy carries the most weight, as it has been found to be most predictive. Starting at 0, adding the weightings for each of the seven factors of a specific loan, results in a fraud score. HMS has intentionally kept the characteristics few and the weightings simple for ease of calculation. A score can be calculated in less than 30 seconds, and the scorecard will likely be committed to memory within a day of use.

The fraud score ranges from 0 to 47. A higher score will have a greater likelihood of fraud. The score provides a relative ranking of fraud risk across a pool of loans. For example, a score of 40 has a higher fraud risk than a score of 35, and both are higher fraud risk than a score of 30. With this ability to rank the fraud risk, limited resources can be allocated to loans having the greatest likelihood of fraud. Illustrating this further, HMS tested the scorecard on a segment of its existing portfolio, not previously identified as fraud. The test results were remarkable: 37% of the segment were confirmed as fraud including the 12 highest scoring accounts.

Ranking the fraud risk provides the ability to set thresholds for which there is an associated risk and reward. HMS has found that fraud scores of 28 and greater, when investigated in detail, have yielded 10-15% positive fraud identifications. This is exceptional considering fraud makes up a fractional percentage of originations. As a result, HMS recommends loans are investigated for fraud if a score is 28 and greater. However, if resources permit, lower thresholds have the opportunity to yield additional fraud identification.

- *Incorporate Fraud Detection in Pre- and Post-Closing Loan Review Process*

Lenders are more frequently incorporating fraud detection processes in the loan origination process as well as in the post-closing Quality Control audits they conduct for loan quality. Both manual reviews and the use of fraud detection scorecards are recommended. Our members have noted the importance of obtaining the IRS Form 4506-T (the form authorizing the release of the applicant's tax return from the IRS) in every file, of verifying social security numbers, of requiring a 24-month chain-of-title verification to eliminate flips, and of using automated valuation technologies to support appraisals. Up-front quality control measures built into the origination process are necessary to detect fraud and help deter it before the loan closes.

- *Take Action Against Perpetrators*

Lenders that have been victimized by fraud, in addition to filing any SAR reports, are reporting fraud to law enforcement agencies and regulators. Some of our members have strong relationships with certain metropolitan FBI offices. These relationships should be developed. Lenders are also making repurchase demands to fraudulent brokers and correspondents if there is any hope of recovery, and bringing civil suits. Lenders are also bringing claims against E&O carriers and title insurers (where appropriate), and providing information to Appraisal Review Boards.

RECOMMENDATIONS:

The following are the CMC's recommendations:

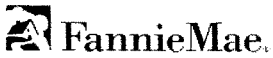
- Establish a publicly available nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations.

- Establish the Federal Housing Administration as a leader in the fight against mortgage fraud:
  - Require the FHA to more aggressively pursue debarment proceedings against individuals involved in fraud against the FHA – too often, the FHA obtains an indemnity from the FHA-approved lender that originated the loan, but does nothing to prevent the actual perpetrators of the fraud – the loan officers, underwriters, and processors – from joining another lender and committing more fraud.
  - Expand FHA's recently proposed rule to "deactivate" real estate brokers from the names list for Single Family Acquired Assets Management System (which allows real estate brokers to be paid for selling FHA-owned properties) to mortgage brokers, appraisers and other market participants.

- Energize the Department of Justice, through the U.S. Attorney across the country, to seek out and pursue prosecutions of mortgage fraud.

* * *

Again we commend the Subcommittee for noting the importance of mortgage fraud on our mortgage origination system and its destructiveness for both unwitting consumers and lenders. While we know that detection is much easier than prevention, the lending community is taking significant steps to root out this illegal behavior. It is critical that more attention be paid to the causes and effects of this growing problem.



Statement by
Brian T. O'Reilly
Director, Product Management, Fannie Mae
Hearing on Mortgage Fraud and its Impact on Mortgage Lenders
U.S. House Committee on Financial Services
Subcommittee on Housing and Community Opportunity

October 7, 2004

Chairman Ney, Ranking Member Waters and Members of the Subcommittee, thank you for the opportunity to file this statement on behalf of Fannie Mae. I applaud the work this Subcommittee has done in examining various aspects of the mortgage process. And, I am pleased to offer this statement regarding the very serious issue of mortgage fraud.

In order to provide some context for these discussions, this statement begins with an overview of current trends regarding mortgage fraud. This statement then goes on to describe initiatives that Fannie Mae has undertaken with our lender partners to address this serious issue.

An Overview – Research Findings

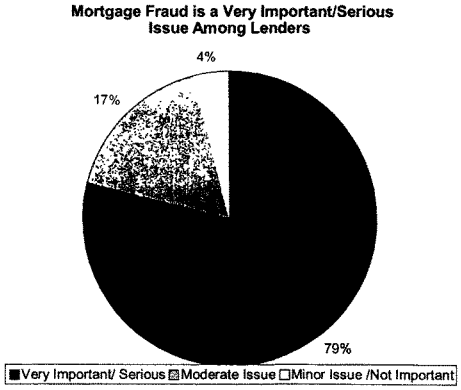
Generally, a finding that mortgage fraud has occurred follows a determination that a material misstatement, misrepresentation or omission of a fact has been made in connection with a loan. To be material, the misstatement, misrepresentation or omission must have been relied upon by an underwriter or lender to fund, purchase or insure a loan.

Examples of material misstatements, misrepresentations and omissions include, falsified income or employment information in the loan application, inflated property values in an appraisal, altered documentation, fraudulent sales contracts, omitted or hidden facts about the loan, and/or misapplication of loan proceeds.

Earlier this year, Fannie Mae worked with a large number of our lender customers to conduct market research on the important subject of mortgage fraud. We worked with an independent consulting firm that specializes in general research of the mortgage industry with particular expertise relating to the uses of technology within the mortgage industry. The goals of that research were twofold: first, to identify the types of fraud that are being perpetrated in the mortgage industry today, and, second, to understand how Fannie Mae can best target its efforts in helping the industry combat fraud.

First, this research confirmed that the vast majority of our lender customers consider mortgage fraud to be an important issue with potentially serious impacts to both them and consumers alike. These lenders also generally believe that the types of mortgage fraud occurring within the industry are becoming more varied and that the fraud schemes and the fraud perpetrators are becoming increasingly sophisticated.

Specifically, 79 percent of our lenders surveyed reported that they consider mortgage fraud to be a very important and serious issue.



Fannie Mae Market Research: March 2004

Mortgage lenders are highly motivated to combat fraud because they recognize the serious adverse economic impact that fraudulent loans have on their business. Based on the findings contained in our market research, the majority of our lender respondents estimate that the average loan loss severity to them resulting from fraudulent loans that go into default is $30,000 per incident.

Second, our research showed that the fraud being perpetrated in the mortgage industry today generally falls into two main classifications -- "Fraud for House" and "Fraud for Profit".

> ***Fraud for House*** is perpetrated primarily for the purpose of buying a property. This type of fraud generally involves fewer individuals and our research findings show that this type of fraud results in relatively smaller credit losses as compared to fraud for profit.
>
> Essentially, the borrowers who commit this fraud generally intend to occupy the subject property and intend to repay the loan. However, the loan documents contain material misstatements, misrepresentations and/or omissions, such as: misstated income or property value, falsified gift/donor information, undisclosed debts, and/or down payment 'gift' funds that, in fact, have been borrowed. These sorts of

misstatements, misrepresentations and/or omissions may result in loans being made to borrowers that otherwise would not qualify for the underlying mortgage.

Fraud for Profit is perpetrated for the purpose of benefiting the parties to the fraud financially. This type of fraud typically involves several individuals working together, often results in multiple fraudulent transactions, and often involves experienced "insider" participation by loan officers, mortgage brokers, appraisers, and closing agents, etc. Because of their affiliation with the industry, these "industry insiders" know the loopholes and weak spots in the system and how best to defraud the lender.

Fraud for profit loans typically contain multiple material misstatements, misrepresentations and/or omissions in the loan file, which may include inflated property values, nonexistent properties or down payments, inflated or falsified assets, fabricated employment and/or inflated income information as well as nonexistent or straw borrowers.

Because loans in this classification are made to individuals that either do not exist and/or do not intend to repay the loan, this type of fraud frequently results in loan defaults within the first 12 months of the loan, or what is generally referred to as an early payment default (EPD). Industry experience indicates that early payment default loans have a very high incidence of foreclosure.

Our research also showed that between these two classifications, fraud for profit -- which often involves collusion among unscrupulous real estate and mortgage practitioners -- is generally viewed by lenders as one of the biggest problems facing the mortgage industry. The insiders that this type of fraud generally involves are sophisticated in their knowledge of the industry. In addition, the ability of these industry insiders to use technology in the perpetration of fraud is also generally high (e.g. generation of fraudulent documents). Thus, the challenge and potential expense of combating this class of fraud, is the greatest.

Third, our lender partners surveyed generally believe that fraudulent activity within the mortgage industry may increase over the foreseeable future. Lack of resources for law enforcement officials seeking to prosecute local incidents of fraud was a leading reason cited by our lender partners for the expected increase in mortgage fraud. Lenders also anticipated that the lower loan origination volumes projected for the next few years might tempt individuals to engage in fraudulent activities in order to maintain their incomes.

According to our research, the fraudulent schemes currently being perpetrated on the mortgage industry that are also most likely to continue into the foreseeable future include:

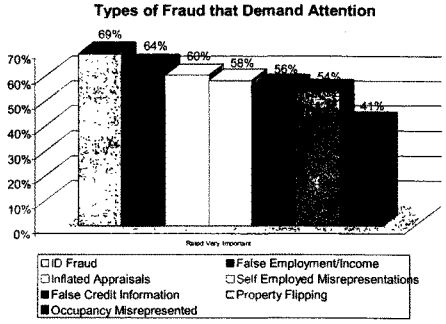
Identity Theft – The fraudulent assumption of a consumer's identity characteristics such as Social Security Number (SSN), Name, Address, Date of Birth (DOB), etc.

Falsified or misrepresented loan application data and support documentation – Today's technology has permitted the production and submission of high quality seemingly authentic fraudulent documents, such as W-2s, tax returns, financial

statements and employment forms, which are used to falsely verify or misrepresent certain material loan application data, including employment, income and asset data.

Artificial Home Price Appreciation – Sellers involved in these schemes fraudulently benefit through one or more property flipping transactions, where artificially higher values are placed on the property in each subsequent sale transaction. Borrowers may also fraudulently benefit from using artificially inflated appraised values in cash out refinance transactions to pull equity that does not legitimately exist in their homes.

Lenders surveyed in our primary market research further indicated that verifying a borrower's identity, validating employment and income, and identifying inflated property appraisals were the areas of fraud detection that most required primary industry focus in the near term.



Fannie Mae Market Research: March 2004

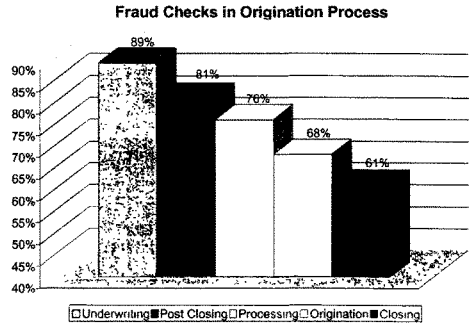
Observations and Insights - Impacts of Fraud On the Mortgage Industry

The increase in incidence of fraud combined with the severity of loss associated with fraudulent loans explains the level of significance that lenders attach to this issue. To be sure, the economic impacts of mortgage fraud on the industry are real and significant. Specifically, lenders face increased credit losses due to fraud (examples include identity theft, and false home price appreciation); lost revenue for originating lenders and/or investors (examples include occupancy misrepresentations by borrowers); and, increased costs associated with regulatory compliance (examples include Patriot Act Compliance).

The added costs associated with mortgage loan fraud, whether as the result of enhanced compliance requirements or as the direct result of losses from fraudulent loans that go into default, will ultimately affect consumers in the form of higher loan costs. Some industry professionals have suggested that the figure may be in the range of several hundred dollars per loan at the low end and could potentially be much higher. Fannie Mae is committed to

providing our lenders with access to fraud detection and prevention tools that will help reduce their risk exposure and the negative economic impacts of fraudulent loans.

Our market research also showed that today a majority of lenders surveyed employ some sort of fraud checking processes – using both manual and/or automated means – during some phases of the loan origination process. However, our research revealed two other very interesting facts in connection with the use of anti-fraud tools by lenders in the loan origination process. First, lenders most commonly use fraud detection in the underwriting and post-closing phases of the loan origination process, and far less at the point of sale. Second, only 17 percent of respondents reported having a fully implemented, automated fraud detection system.



Fannie Mae Market Research: March 2004

Effective fraud detection and prevention requires broad availability and use by lenders of automated fraud detection tools at the earliest phase of the loan origination process – the point of sale. Our recent research validates this view. Indeed, common themes among lenders surveyed included: 1) pushing the use of fraud detection to the point of sale would be optimal in combating fraud, and 2) replacing manual fraud checks with automated fraud detection processes would ensure a higher degree of consistency and objectivity in lenders' fraud detection and prevention efforts.

Currently, the use of automated fraud detection technology systems at the point of sale is quite limited, with only a small sample of lenders surveyed using such technology at that early stage in the loan origination process. The predominant reasons lenders cited for this include:

- Integration of these technologies at point of sale can be very complex, and the integration requirements often vary from vendor to vendor;
- The costs of integration and maintenance can be prohibitive;

- There are a large number of service provider suppliers offering these tools – lenders feel that they need more information to determine which providers are the most viable long-term and which tools are most valuable;
- There is an impression that the data returned by these service provider tools is often inaccurate; and
- Lenders often believe that to be useful to them, these tools must be customized.

Current Initiatives - Fannie Mae Providing Leadership to Combat Mortgage Fraud

Earlier this year, Fannie Mae announced the Expanded American Dream Commitment®, where the company pledged significant new resources through several dozen new and enhanced mortgage initiatives to achieve the following goals:

- Expand access to homeownership for millions of first-time home buyers and help raise the minority homeownership rate to 55 percent with the ultimate goal of closing the homeownership gaps entirely;

- Make homeownership and rental housing a success for millions of families at risk of losing their homes; and

- Expand the supply of affordable housing where it is needed most, which includes initiatives for workforce housing and supportive housing for chronically homeless.

Included within this Expanded American Dream Commitment was an initiative aimed at leading the industry in expanding responsible lending by increasing the chances of successful home ownership. Specifically, the company pledged to work with lenders and service providers to protect borrowers and combat the costs in the mortgage origination process that result from fraud.

Fraud is not just an industry problem—it affects borrowers as well as neighborhoods. Many types of mortgage fraud involve predatory lending practices. Too often borrowers are the victims of predatory practices, such as property flipping, over-valuation in appraisals, falsified loan applications where the loan officer or mortgage broker misstates information, such as income or employment. In these instances the borrower ends up paying too much for a house that is over-valued or in deteriorating condition or secures a loan that he or she cannot realistically afford to repay.

Although the direct focus of Fannie Mae's efforts are aimed at providing lenders with access to tools that can be used by them to detect data misrepresentations and/or fraud at the point of sale and before loans close, we adamantly believe that success in this effort will translate into tangible benefits to consumers in the form of lower loan origination costs and more successful homeownership outcomes if predatory practices can be eliminated.

At the heart of Fannie Mae's effort to deliver automated fraud detection tools to lenders at the point of sale, is our initiative to develop an Anti-Fraud Service that is available to our customers through Fannie Mae's DU Connections. By way of background, DU Connections is the name of a Fannie Mae service that enables our customers to obtain electronic,

automated access to a variety of loan fulfillment services offered by third-party providers. Currently, Fannie Mae's customers can order directly through DU Connections credit reports and mortgage insurance. Fannie Mae has taken an open platform approach to those services and has integrated all of the industry leading credit and mortgage insurance providers to this Fannie Mae network. By accessing those services through DU Connections, lenders are able to obtain these services cost effectively through a single technical integration point.

Fannie Mae's Anti-Fraud service is being developed and will be implemented using the same open platform approach, meaning that Fannie Mae intends to provide access to the platform to all best-in-class anti-fraud service provider companies. Using Fannie Mae's Anti-Fraud Service, lenders will have cost effective access to best-in-class anti-fraud service provider partners whose anti-fraud tools can then be used to detect key data misrepresentations and/or fraud *before* loans are closed. By making these tools available at point of sale, consumers will also benefit whenever lenders use these tools to detect, for example, fraudulent activities such as identity theft.

This past summer, as part of a limited project aimed at validating market interest in anti-fraud tools at the point of sale, we launched a pilot version of our Anti-Fraud Service. Using that service our lenders could access an automated Verification of Employment (VOE) service provided by the TALX Corporation. The TALX VOE Service uses the Social Security number from the loan application and checks that against its database of employer and employee records. If there is a match, a report is returned that contains the following information for verification purposes: employee name and Social Security Number, employer name and address, employment status, most recent start date, total time with employer and job title. Lender response to this limited pilot offering has been excellent.

Our primary market research and our customers have identified VOE, VOI (Verification of Income), and Borrower ID Verification as the three most desired anti-fraud services. In response, by year-end Fannie Mae will introduce a production version of its Anti-Fraud Service. The enhanced Anti-Fraud service will include more anti-fraud tools, providing access to VOI as well as Borrower Identification Verification capabilities, in addition to our current VOE capability. These tools include:

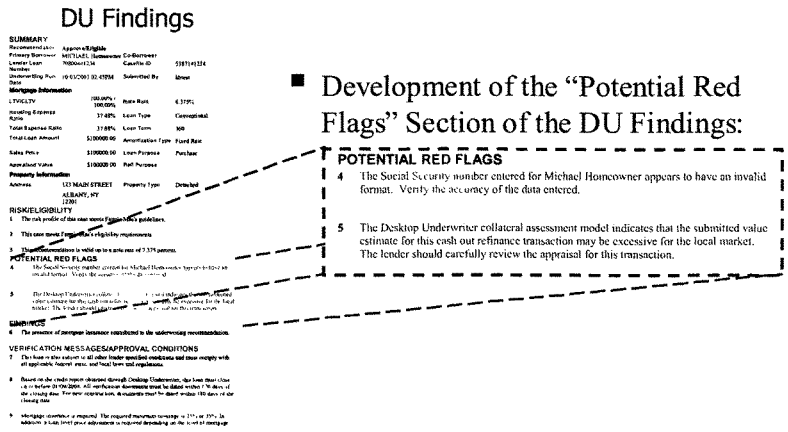
> Verification of Income: verifies employment income data such as base pay, overtime, bonuses, commissions, and other income.
>
> Borrower Identity Verification: verifies borrower name, address, telephone, SSN, DOB, and driver's license number as well as determine if the borrower's name appears on the OFAC list of known terrorists and money launderers. In addition, these services can leverage data from multiple databases to provide a risk assessment score or confidence level to identify accounts with the highest likelihood of fraud.

In addition, we continue to work with our lender partners and other anti-fraud service provider partners to identify other fraud detection tools that we expect to make available to our lenders through enhancements to this Anti-Fraud Service in 2005.

In all cases, Fannie Mae plans to partner with "best in class" third-party service providers that offer data verification solutions that are directly integrated to our Anti-Fraud Service. This will facilitate faster time-to-market of a comprehensive anti-fraud 'solutions suite' and mitigate our lenders' risk exposure to many of the key areas of mortgage fraud.

Additionally, this approach addresses one of our lenders' key concerns with respect to the delivery of anti-fraud solutions at the point of sale, because it provides our lender partners with a single point of technical integration in order to access these services. Not only does this make it easier for lenders to integrate these processes into their systems in the first place, but it will also make these systems easier to use on a day-to-day basis by providing access to tools that may be integrated into their loan origination systems and Desktop Underwriter® (the Fannie Mae automated underwriting system). This approach substantially reduces the costs to our lenders to implement these anti-fraud tools, thereby eliminating a key barrier to their adoption within the mortgage industry.

Fannie Mae has also recently enhanced data integrity messaging in Desktop Underwriter (DU™). As noted earlier, these findings will alert lenders to potential areas of concern that may warrant additional scrutiny before approving a mortgage loan. As illustrated below these findings are included in a new "Potential Red Flags" section to the underwriting findings in DU that provides one central location for these messages within the underwriting findings.



Potential "Red Flag" messages include:

Excessive Value – Comparison of subject property value to Fannie Mae property data and valuation models.

Valuation Risk – Characteristics of the loan are highly correlated to loans with appraisals that have historically displayed excessive values.
Liabilities on theLoan Application vs. Credit Report variance – Difference between value in the liability section of the 1003 and the credit report exceeds tolerance.
SSN Validation –

- Invalid Format – number of digits or value associated with specific position is not valid
- Not Issued – Social Security Administration has not issued the SSN yet
- Year of Issuance – Year associated with SSN issuance is prior to the borrower's date of birth
- Death Master File – SSN is on the Death Master File provided by SSA

Occupancy misrepresentation – Borrowers claim rental or second house as a primary residence.
Rapid Appreciation – Loans with excessive rapid appreciation will be identified.
Excessive multiple resubmissions – Loans that are resubmitted through DU an excessive number of times are more likely to have data misrepresentation issues.

Fannie Mae will continue to work to identify additional opportunities to enhance the findings in DU in order to constantly improve the quality and character of information available to our lender partners, and we anticipate that we will make available additional anti-fraud findings messages available in DU in 2005.

Conclusion

By offering lenders access to automated fraud detection services at the point of sale and by expanding the DU findings to include specific anti-fraud messages, Fannie Mae seeks to achieve the following goals:

- Assist lenders in their efforts to avoid making loans that involve misstatements, misrepresentations or omissions;
- Reduce lenders' risk exposure to assist in the mitigation of losses due to fraud;
- Create sustainable homeownership opportunities for consumers by averting predatory practices;
- Reduce mortgage origination costs to lenders and, in turn, consumers, through improved risk management capabilities and automation of current manual loan data verification processes;
- Provide lenders with operational flexibility and cheaper access to these tools by allowing them to gain access to multiple fraud mitigation tools while spending resources to integrate only once to a single anti-fraud service; and,
- Move fraud detection forward in the origination process to as close as possible to the point of sale.

Fannie Mae believes that it has a unique responsibility to help address the Nation's toughest housing problems, including the prevention and elimination of mortgage fraud. We look forward to the opportunity to continue to work with the lending industry to harness

technology to deliver efficient, cost-effective fraud detection and prevention tools to combat the costs of fraud in the mortgage origination process. In addition, we look forward to working with Congress and this Subcommittee on this important issue and would be happy to respond to further questions or requests for information.

Thank you for the opportunity to provide this important information to the Subcommittee.

5230 las virgenes road, suite 275, calabasas, ca 91302
818.871.1922 800.333.4510 fx 818.871.1941

October 4, 2004

Clerk of the Committee
c/o Cindy Vosper Chetti
Senior Professional Staff
Committee on Financial Services
2129 Rayburn House Office Building
Building - B303
Washington, DC 20515

RE: Subcommittee on Housing and Community Opportunity
"Mortgage Fraud and Its Impact on Mortgage Lenders"
Thursday, October 7, 2004 at 10:00 a.m. Eastern

Dear Ms. Chetti:

In accordance with your invitation to submit a written statement to the Committee on Financial Services, I am submitting this letter as Sysdome's written testimony. The mortgage/financial services market is at risk for fraud, and we believe that the problem will continue to increase as the overall mortgage origination market dwindles from $3.8 trillion to a forecasted $2.7 trillion[1]. Despite a decreasing market due to higher interest rates, individuals are more prone to misstate information on their mortgage applications to meet the cost of the higher interest rates or participants in the loan origination process, who need to meet their past levels of incomes, intentionally defraud the lender.

The mortgage origination process is very complex and depersonalized with many individuals touching the application from point of application through underwriting and ultimately securitization. Over the past thirty years the process has seen a shift from loyalty to a local financial institution by the consumer to an origination environment that demands fast service, best pricing and increasing loan amounts. In this new environment many consumers have chosen to use a mortgage broker, or third party originator, to provide faster service and the best possible price. Third party originators, now account for approximately 60-70% of all mortgage originations.[2]

It has been estimated that 10-15% of all loan applications contain material misrepresentations, such that if the true information were known to the lender, the loan would not be made. The FBI recently stated that as high as 25% of applications contain material misrepresentations in the sub-prime market. Sysdome believes that the proper term for intentional material misrepresentation" is more accurately defined as "fraud", and includes such misrepresentations and omissions as:

[1] Mortgage Bankers Association Forecast, September 2004
[2] Ownlt Mortgage

- False information contained in the 1003 Form (mortgage applications) and/or financial statements
- Inflated appraisals
- Document modification
- Fraudulent sales contracts
- Misapplication of loan proceeds
- Hidden facts

Fraud can be segmented into two distinct categories: Fraud for housing and fraud for profit. Fraud for housing is typically perpetrated by well-meaning, but unqualified, borrowers that are not looking for financial gain and simply want a loan to gain access to a home. Income and property values may be altered, down payments may often be borrowed and undisclosed debt for credit cards, personal loans, automobiles or life insurance may exist. The borrower, however, intends to repay the loan, and the result of a default often results in a smaller loss to the lender.

Fraud for profit is much more serious as the intention is to defraud the lender for profit and may occur on a much larger scale which will result in potentially much larger losses. Numerous misrepresentations are typically found in a file with the property values being highly inflated, down payments may not exist, employment and income are often either totally fabricated or dramatically inflated, identity fraud is widely perpetrated and the borrowers may not exist, and the entire fraud perpetrated is methodical, organized and well executed. The "borrower" has no intention to repay and the resulting default results in larger and often total loss to the lender.

Among the fraudulent schemes that are executed today include:

- **Identify Theft** – *Fastest growing white collar crime in the country where a real person's name and information is used without their knowledge and isn't typically involved in the transaction.*
- **Strawbuyers** – *An individual is used to serve as a cover for a questionable transaction, sometimes solicited and paid for their services to gain the mortgage approval. Often the individual is a relative or friend where the consequences may not be understood, but the applicant has no intention of owning or occupying the property, and the personal information included may or may not be accurate.*
- **Property Flipping** – *Artificially inflating market value in a specific area by selling and continuous reselling of property(s) at increasing prices based upon fraudulent appraisals. End goal is to obtain larger loans and to "skim" the equity off of the property.*
- **Builder Bailout** – *Builder or developer manufactures a sale to sell property quickly, or in a depressed or falling market, to repay a construction loan.*
- **Foreclosure Bailout** – *Homeowner in financial distress will sell a property to a fictitious person or strawbuyer to get out of a mortgage obligation.*
- **Application Fraud** – *Materially false information used in creating a mortgage application for the purpose of defrauding the lender for profit.*

Although it is well known what the types of fraud categories are, and the industry is attempting to address them with both manual and automated technology tools and processes, the extent of the problem is less definitive. No standard definition of fraud is used throughout the industry, nor is there a standard approach to reporting fraud in aggregate. Sysdome has attempted to quantify the potential problem by extrapolating from the mortgage applications ***at risk*** using the figures already quoted above. If the mortgage origination market is forecasted to be $2.7 trillion in 2005, and it is believed that 10-15% of all applications contain materially false information, using the lower end of the estimate as a floor it is logical to conclude that $270 billion is at risk.

Mortgage fraud differs from predatory lending in that fraud is perpetrated by borrowers, appraisers, brokers or criminals against lenders, and predatory lending is perpetrated by lenders against borrowers. These are two totally different issues and the one being addressed here, as we understand the task, is concerned with mortgage fraud. As defined above, or even under more conservative estimates, the potential for mortgage fraud damage is massive.

Having addressed the complexity of the mortgage origination environment, the problem of mortgage fraud in general, and the types being perpetrated today in two distinct categories, the next topic ought to be what is being done to solve the problem. The problem is being addressed aggressively by both lenders and corporate for-profit initiatives offered by companies such as Sysdome.

Lenders maintain underwriting processes where a Quality Control (QC) group audits 5% to 15% of their production volume depending on the sophistication of the lender and the number of mortgage involved. Typically, these QC procedures are done "after the fact" where the mortgage has been funded and the fraud, if any, completed. Underwriting guidelines are constantly reviewed and managed to predict which application profiles ought to be more thoroughly reviewed and then others are randomly audited. This QC group serves as a check-and-balance to the Production (sales) Department responsible for getting and processing loan applications. However, with the criminals having better access to technology, and with the constantly changing schemes which can now be deployed quickly throughout the country, this random audit process is insufficient alone to prevent or accurately predict fraud potential.

New tools are being deployed by lenders, such as Sysdome's technology, that increases a QC groups' efficiency and they are now able to analyze all incoming loan applications at the beginning of the origination process before a fraudulent mortgage can be completed. This early stage review applies a consistent underwriting process on all loans and ranks the entire production process by application quality ensuring that the audit selection of loan applications are reviewed more extensively by the QC group.[3] Without changing any internal processes, the technology applied at the application stage allows a lender to better validate, verify and authenticate the data and then interpret it as to its fraud risk thereby assigning the riskiest applications to the QC group.

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[3] See Exhibit A through C

Additionally, increased focus on quality at the beginning of the origination process allows tracking of loan performance to all participants in the origination process. Currently most repurchase obligations and the resulting losses, due to fraud, fall upon the lender and not the mortgage broker as they typically don't have the financial ability to pay. It has been estimated that 42 basis-points (0.42%) are spent by a lender, from origination to securitization, on ensuring "loan quality". In other words, on a $150,000 loan, the cost of ensuring against fraud and loan quality is approximately $630.[4] This is money that could be saved by the industry and ultimately passed on to the consumer in the form of lower closing costs.

Sysdome recommends that the best and most efficient approach to preventing mortgage fraud includes the following steps:

1. Deployment of state-of-the-art technology at point of origination that screens applications at the point of submission whether through the retail or internal distribution channel of a lender, or through a mortgage broker.

2. Centralized tracking of all individuals that touch a mortgage application, including the loan officer, mortgage originator, appraiser, etc., by assigning a unique identifier to that individual that will stay with the mortgage application through the life of the mortgage loan.

Thank you for the opportunity to present our thoughts on this problem. We look forward to participating in any forum that addresses how best to attack mortgage fraud.

Sincerely,

/s/Kevin D. Coop

Kevin Coop
President & Chief Executive Officer
Sysdome, Inc.

[4] OwnIt Mortgage

Electronic Loan Review™

Fraud Prevention through Data and Technology

About ELR 5.1

ELR 5.1 is a mission-critical decision support tool for mortgage lenders, insurers or brokers. It is based on Sysdome's proprietary relational database that uses complex algorithms and investigative logic to interrogate and validate loan application data, and then provides recommended actions.

Put ELR 5.1 to work for you!

ELR 5.1 provides more information than previously possible – in a matter of seconds!

ELR 5.1 checks loans at the point of application, as well as at the pre- and post-funding stages.

Our comprehensive review covers everything from identity theft and straw buyers to property flips and more, including the ability to customize based on your requirements!

ELR 5.1– The Clear Advantage

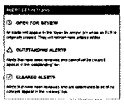
- Front-End Decision Tool vs. Bank-End Analysis
  Stop fraudulent loans BEFORE they're funded!
- Exception Based Reporting vs. Data Dumping
  Let Sysdome 's ELR analyze the data so you don't have to!
- Proprietary Fraud Database
  Our database gets smarter with each loan submitted!

ELR 5.1 Functionality

Sysdome's new ELR 5.1 is looking better than ever and performing with enhanced functionality designed to SAVE YOU TIME. Simply put, ELR 5.1 delivers the fraud prevention features and benefits you've been asking for!

Interactive Reports

ELR 5.1 reports are HTML-based, allowing you to clear alerts and add comments directly to the report.



Increase workflow with Email Capability

Wouldn't it be nice to simply email or "route" an ELR to a colleague or supervisor when necessary? Now you can! With the simple click of a button, the recipient will receive an email with your comments and a direct link to the ELR report.

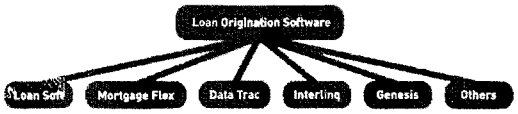
Free Updates!

You can now update your original loan information free of charge! Simply click the "Edit Loan File" button at the top of the ELR Report, fill in your new data, and click "update." Your changes are immediately processed. When you return to the ELR report, you will see firsthand how your new data has affected it. The report will be rescored based on the data you've just entered.

sysdome
www.sysdome.com

Sysdome, Inc. 800-333-4510 818-871-1941fx Email: sales@sysdome.com

Asset Protection through Data & Technology



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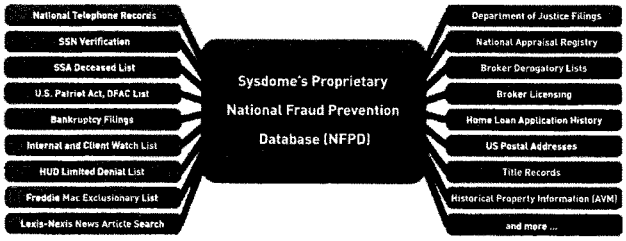

sysdome
ELR v5.1

Interview Date: 09/20/03
Original ELR Date: 10/01/03 - 6:10am PST
Last Update: NA
Current ELR Date: NA

ABC Mortgage Company

ELR #:120000
Score: 400
Lender Case: 12345
Agency Case: 45-222333
Submitted by: janelender
Route this ELR

SUBMITTED LOAN INFORMATION

Edit Loan Info

Borrower(s) Name Social Security #			Street Address City State Zip Phone Age	Employer / Self-Employed? Street Address City, State Zip Phone
Stuart 584-06-3388	M	Robinson	45 Oak Park Place Any Town, CA 99999 (310) 999-9999 37	Ford Motor Co / N 4211 S. Juniper Dr Los Angeles, CA 94224 (818) 999-2424
Dawn 526-10-2333	_*_	Robinson	45 Oak Park Place Any Town, CA 99999 _*_ 37	Applicant Realty Co / Y 272 E. Hill Street Los Angeles, CA 92614 (323) 823-8876

SUBJECT PROPERTY	MORTGAGE ORIGINATOR	APPRAISAL COMPANY
Street: 123 Main Street **City:** Anytown **State, ZIP:** CA 99999 **Loan Type:** Conventional NOTE: Review all of the above information and confirm. Information not submitted noted with "_*_".	**Company Name:** Home Mortgage Co. **Street:** 444 Park Lane **City, State, ZIP:** Los Angeles, CA 99999 **Representative:** John Stripes **Rep. Phone #:** (310) 555-2316 **Loan Purpose:** Purchase	So. Cal Appraisals _*_ Betty Stripes (310) 222-2222

PRICE & VALUE DATA				PRICE & VALUE METRICS			
Loan Amount	**Appraised Value**	**Purchase Price**	**AVM**	**LTV**	**Loan to Price**	**AVM/Price**	**Appraised Value Price**
$100,000	$95,000	$118,000	$95,000	105%	85%	81%	81%

Note: OFAC Matches have not been identified.

SYSDOME ALERTS

(Alerts are listed first by STATUS, then category and rank)

OPEN FOR REVIEW — CHANGE ALERT STATUS/ADD A COMMENT:

[R] EMPL-1069

Employer (exact match) has been subject to a BANKRUPTCY and the Borrower is SELF-EMPLOYED.

Employer Name: Applicant Realty Co.
HISCourtID: CAMARF1
Filing Date: 12-28-1999
Release Date: 04-05-2000

Recommendations

1. Provided for informational purposes as employment may not be stable. Review filing date/release date to determine stability.
2. Confirm the company is still active and owned by the borrower.

[Y] APRA-6500

Potential Conflict of Interest - Appraiser and Loan Officer same last name.

Appraiser Name: Betty Stripes
Loan Officer Name: John Stripes

Recommendations

1. Obtain explanation and determine potential impact on situation.
2. Look for inconsistencies between Appraised Value and AVM if provided.
3. Order an independent appraisal if necessary.

OUTSTANDING ALERTS — CHANGE ALERT STATUS/ADD A COMMENT:

[R] BRWR-1049

SSN is retired.

Submitted SSN: 526-10-2333
DOB: 10/08/1907
Date of Death: 2/18/2000

Recommendations

1. Verify accuracy of the data input of the SSN.
2. Confirm directly with the Social Security Administration using Sysdome's SSN DIRECT

COMMENT
10/01/03 - 9:45am
janelender

Ordered SSN Direct from Sysdome. Should have reply tomorrow.

ORGR-1058

Originator Name identified is similar to one on Client Watch List.

Originator Name: Home Mortgage Co.
Watch List Name: Home Mortgage Company

Recommendations

1. Verify listing on Watch List.
2. Investigate reasons for listing.
3. Consult with internal department responsible for list to determine impact on transaction.

COMMENT
10/01/03 - 9:55am
janelender

Michelle is researching to determine if these are the same originator. It appears that two companies have the same name. She will let me know by Friday.

CLEARED ALERTS — CHANGE ALERT STATUS/ADD A COMMENT:

[R] PROP-5555

The variance in purchase price (or appraised value) for this property shows greater than a 20% annualized growth rate.

Submitted Address: 123 Main Street, Anytown, CA 99999
Submitted Appraised Value: $95,000
Submitted Purchase Price: $118,000
1st Prior Sales Price: $92,000
1st Prior Sales Date: 09/20/02
1st Prior Seller's Name: John Jacobs
Yearly Increase in Value: 28.2%

Recommendations

1. Review details to determine if sales price has increased more than accepted regional appreciation rate.
2. Order an investigation / review appraisal when appreciation rate is excessive.

COMMENT
10/01/03 - 1:35pm
janelender

Review appraisal indicated that the property has had significant improvements and is one of the nicer properties in the area. Increase appears warranted.

COMMENT
10/01/03 - 1:35pm
jmanager

Approve clearing of this Alert as well as PROP-1156.

PROP-1156

By comparing AVM to purchase price (or Appraised Value) it has been determined that the subject property value is possibly inflated.

Submitted Address: 123 Main Street, Anytown, CA 99999
AVM: $95,000
AVM Date: 10/01/03
Sales Price or Est. Value: $118,000
Submitted Appraised Value: $95,000
Application Date: 09/20/03
Loan Purpose: Purchase
Variance: (24.1%)

Recommendations

1. Order a field review appraisal to determine accuracy of appraisal.
2. Evaluate results of review appraisal and determine the impact on the transaction.
3. Order investigation.

COMMENT
10/01/03 - 1:35pm
janelender

Review appraisal indicated that the property has had significant improvements and is one of the nicer properties in the area. Increase appears warranted.

[G] BRWR-5400

Borrower phone number not provided.

Submitted Name: Dawn Robinson

Recommendations

1. Obtain telephone number. Input and resubmit

COMMENT
10/01/03 - 1:35pm
janelender

Obtained phone number for borrower and input information using iELR. Reran process. No issues with new number. Same as coborrower.

Client should not use the Sysdome ELR InterActive Data as a basis upon which to make a decision of whether or not to extend credit. Client must conduct his or her own due diligence, underwriting review, or analysis. Client agrees to use Sysdome's online FraudGuard services in accordance with Sysdome's Service Agreement. FraudGuard services are provided to Sysdome's clients only. All other use is prohibited.

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SafeCheck Results

Client: ABC Mortgage
Requested By: Lender, John

Trans ID/Loan #:
Date Requested: 12/17/2003

Submitted SSN: 312-38-4316

Print This Page | Search Again

ALERTS FOUND! DETAILS BELOW.

SafeCheck Alert Details:

1. Multiple names are associated to the requested SSN

Best Match Name: TONY KWIATKOWSKI
SSN Issue Date: 1953-1956
Calculated SSN Age: 61

Assigned State: IN
Birthdate of Deceased: N/A
Date of Death: N/A

BEST MATCH CONSUMER INFO: *(NOTE: # - represents the number of times name has been associated with SSN)*

SSN	NAMES (Best Match Listed First)	#	BIRTH YEAR	SPOUSE	ADDRESSES (for Best Match)	ADDRESS REPORTED
312-38-4316	TONY KWIATKOWSKI ANTHONY KWIATKOWSKI ANTHONY P KWIATKOWSKI TONY P KWIATKOWSKI	6	1942		6912 POLK AVE PORTAGE, IN 46368-1725	06/88-01/02

EMPLOYERS ON BEST NAME:

EMPLOYER NAME	ADDRESS	RPT DATE

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OFAC Check Results

Client: ABC Mortgage
Requested By: Lender, John

Trans ID/Loan #: 9615817
Date Requested: 12/17/2003

Search Criteria: TONY KWIATKOWSKI

No Records Found

We found no record for **TONY KWIATKOWSKI** in the OFAC database.

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asset protection through data & technology

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Consumers should report data inaccuracies or potential fraud to the credit bureaus directly. Experian (888) 397-3742; Trans Union (800) 680-7289; Equifax (800) 685-1111.

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Sysdome's Third Party Review

Sysdome's Third Party Review (TPR) is a faster, easier, more affordable system for reviewing the backgrounds of mortgage brokers or appraisers. It's a great solution for up front broker application review or annual renewals. It also allows for the detection of fraud throughout the loan process: at point of application, point of processing, etc.

TPR is an important component in having key data verified to maintain quality control. With proper authorization, the TPR process includes the following:

TPR

- Contact state licensing agency for current status
- Request derogatory state licensing information, if provided by the state
- National Fraud Protection Database (NFPD) Review
- OFAC compliance with the U.S. Patriot Act, Section 23
- Lexis Nexis news article search
- Lenders/Industry Sanctions search
- SafeCheck SSN Verification for principals (false identities)
- Bankruptcy Search
- Industry and client watch lists (Freddie Mac, HUD LPD)

The finished Alert Report speaks volumes without pages of complexity, pinpointing areas of concern so you look directly at the problems and make quick decisions.

[Report after report of mortgage fraud hits news wires on a regular basis, with stories of lenders and innocent sellers being cheated out of billions.]

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ASSET PROTECTION THROUGH INFORMATION AND TECHNOLOGY

THIRD PARTY REVIEW REPORT

TRANSACTION SUMMARY

Client Name	A+ Lender	**Telephone No.**	111-111-1111
Contact Person	John Doe	**Fax No.**	111-111-1112
Date Requested	10/23/2000	**Loan No.**	0123456
Report Date	10/23/2000	**Report No.**	222222
Search Subject	Mickey Mouse Mortgage	**Lic. Exp. Date**	04/30/02
License No.	MB1234	**Lic. Exp. Date**	12/31/03
License No.	CL5678	**Lic. Exp. Date**	01/01/02

SEARCH SUBJECT

Categories Searched:

- ✓ Affinity National Fraud Prevention Database Review
- ✓ License Validation
- ✓ Freddie Mac's Exclusionary List Review (for Freddie Mac Seller/Servicers only)
- ✓ Social Security Number Validation
- ✓ Bankruptcy Record Review
- ✓ HUD LDP List Review
- ✓ OFAC List

Alert Code:	Alert Description:	Alert Detail:
1350-9000	Identified with suspected fraudulent activity	Name: Mickey Mouse Mortgage
1350-9001	Entity is subject to a pending or completed civil or criminal action	Name: Mickey Mouse Mortgage Address: 123 Street, Anytown, CA
1350-9002	Based on your information request, no derogatory data has been found	
1350-9003	Certain information requested was contained in the National Fraud Protection Database and may warrant further inquiry by Client	Name: Mickey Mouse Mortgage Address: 123 Street, Anytown, CA Effective Date: 12/16/1999 (if applicable) Document: Los Angeles Times-December 16, 1999 Source: Los Angeles Times Mirror Company Action: Federal authorities, announced criminal charges against 3 California mortgage loan brokers, real estate professions, escrow agents and others. Violation: Accused of obtaining fraudulent FHA-insured loans.
1350-9004	Name not provided	
1350-5201	No license information provided	Name: Mickey Mouse Mortgage Comments: License information not verified.
1350-5202	State licensing agency does not provide or verify license data	License no.: MB123456 Name: Mickey Mouse Mortgage Source: State Licensing Agency

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