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## DRAFT

### Burning Down the House:

#### Mortgage Fraud and the Destruction of Residential Neighborhoods

Mortgage fraud is bank robbery without a gun.<sup>1</sup> It is a high-yield,<sup>2</sup> low risk enterprise that has been reported in all 50 states, Puerto Rico, Guam, American Samoa,<sup>3</sup> Canada,<sup>4</sup> New Zealand,<sup>5</sup> Australia,<sup>6</sup> and England.<sup>7</sup> In the United States, it is committed by organized international and domestic rings,<sup>8</sup> street gangs,<sup>9</sup> terrorists,<sup>10</sup> drug traffickers,<sup>11</sup> real estate agents,<sup>12</sup> closing attorneys,<sup>13</sup> appraisers,<sup>14</sup> mortgage brokers,<sup>15</sup>

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<sup>1</sup> The targeted victims distinguish mortgage fraud from predatory lending. In predatory lending cases the borrower is victimized by the illegal practices of the lender or its agents with respect to fees and disclosures relating to the cost of the loan. It is unfortunate that the media, consumer activists, legislators and law enforcement personnel frequently conflate mortgage fraud with predatory lending since it adds unnecessary confusion to an already complex issue and diverts attention and badly needed resources from the fight against true mortgage fraud.

<sup>2</sup> The average "take" on a bank robbery is approximately \$3,000.00. By contrast, the average straw borrower receives a "cut" of at least \$10,000 and the orchestrator's "take" in a mortgage fraud transaction frequently exceeds \$100,000. In a few cases the orchestrator's take was in excess of \$1 million dollars, and in one, the perpetrator, who later fled the country, received \$7 million in "profit" from the same-day flip of a mansion.

<sup>3</sup> Financial Crimes Enforcement Network, "Mortgage Loan Fraud: An Industry Assessment Based on Suspicious Activity Report Analysis," November 2006 at 10. [http://www.fincen.gov/news\\_room/rp/reports/pdf/mortgage\\_fraud112006.pdf](http://www.fincen.gov/news_room/rp/reports/pdf/mortgage_fraud112006.pdf) (accessed March 8, 2009).

<sup>4</sup> See, e.g., "Due Diligence: The Growing Problem of Mortgage Fraud), CBC News, November 9, 2006. <http://www.cbc.ca/news/background/mortgage-fraud/> (accessed January 4, 2010).

<sup>5</sup> See, e.g., Anne Gibson, "Agents on Charges for House Fraud Sale," New Zealand Herald, December 26, 2006. [http://www.nzherald.co.nz/property/news/article.cfm?c\\_id=8&objectid=10361509](http://www.nzherald.co.nz/property/news/article.cfm?c_id=8&objectid=10361509) (accessed January 4, 2010).

<sup>6</sup> See, e.g., "Australia Targeted by Card Skimming Gangs," October 14, 2009. <http://www.abc.net.au/news/stories/2009/10/14/2714003.htm?section=australia> (accessed January 4, 2010).

<sup>7</sup> See, e.g., Richard Edwards and Myra Butterworth, "Toxic Debt Could Have Come from Massive Mortgage Frauds," *The Daily Telegraph*, March 10, 2009. <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/4970457/Toxic-debt-could-have-come-from-massive-mortgage-frauds.html> (accessed January 4, 2010).

<sup>8</sup> See, e.g., *U.S. v. Bowens*, 2:07-CR-00544 (D.Ariz. 2007) (defendants convicted of scheme conducted over five years in three states involving 19 properties and 10 vehicles).

<sup>9</sup> See, e.g., David Jackson, "Mortgage Fraud is the Thing to Do Now," *Chicago Tribune*, Nov. 5, 2005.

<sup>10</sup> See, e.g., *U.S. v. Omar*, 2:06-CR-756, superseding indictment (D. Utah 2006), and Patrick Poole, "Mortgage Fraud Funding Jihad," *FrontPageMag.com*, April 11, 2007. <http://www.frontpagemagazine.com/articles/Read.aspx?GUID=2FB5D093-D93D-404B-B4CD-AEEA3DB9CEBF> (accessed March 8, 2009).

<sup>11</sup> See, e.g., United States Immigration and Customs Enforcement press release, Nov. 19, 2008. <http://www.ice.gov/pi/nr/0811/081119newyork.htm> (accessed March 8, 2009).

<sup>12</sup> See, e.g., *U.S. v. Rice*, 1:2002-CR-00691 (N.D. Ga. 2002).

<sup>13</sup> See, e.g., *U.S. v. McFarland*, 1:04-CR-224 (N.D. Ga. 2004) (superseding indictment); *U.S. v. Sprouse*, 3:07-CR-211 (W.D. N.C. 2007) (fourth superseding indictment).

<sup>14</sup> See, e.g., *U.S. v. Ross*, 5:06-CR-40068 (Kan. 2006) (first superseding indictment).

<sup>15</sup> See, e.g., *U.S. v. Hooker*, 2:05-CR-80897 (E.D. Mich. 2005).

bank executives,<sup>16</sup> ministers,<sup>17</sup> teachers,<sup>18</sup> policemen,<sup>19</sup> and, frequently, neophyte property investors.<sup>20</sup>

In the federal courts, mortgage schemes are charged as bank fraud,<sup>21</sup> mail fraud,<sup>22</sup> and wire fraud<sup>23</sup> and, depending on the specific structure of the scheme, conspiracy to commit bank fraud,<sup>24</sup> money laundering,<sup>25</sup> aggravated identity theft,<sup>26</sup> bankruptcy fraud,<sup>27</sup> and/or false statements.<sup>28</sup> A handful of states have statutes that address mortgage fraud as a specific crime,<sup>29</sup> but in most state courts it is charged, if at all, as theft or grand larceny.

Although the variety of schemes is infinite and limited only by the human imagination,<sup>30</sup> they are generally classified as either fraud-for-profit or fraud-for housing.

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<sup>16</sup> See, e.g., U.S. v. Gordon, 08-21103-Jordan (S.D. Fla. 2008) (bank's managing director altered individual's credit data to inflate mortgage pools' apparent quality and value upon sale to investors); U.S. v. Levine, 1:09-CR-00554 (N.D. Ga. 2009) (executive vice president in charge of bank's community redevelopment lending department accused of knowingly over-valuing bank assets (loans to flippers) in reports to the OCC and the FDIC; the defendant is expected to plead guilty in January, 2010)..

<sup>17</sup> See, e.g., U.S. v. Sailor, 1:08-CR-105, superseding information (N.D. Ga. 2008).

<sup>18</sup> See, e.g., U.S. v. Sprouts, 2:08-CR-0051 (W. D. Pa. 2008).

<sup>19</sup> See, e.g., U.S. v. Culp, 3:08-CR-00055 (N.D. Ind. 2005).

<sup>20</sup> "Investor" borrowers on known fraud loans typically report that they were lured into the scheme by perpetrators who offered hands-off "turnkey" investment programs. The perpetrators promised to acquire the properties at less than market value with cash back to the borrower/investor at closing, to rehab the properties, to find tenants at a monthly that would provide passive monthly income in excess of the mortgage payment, and to manage the property for a year, after which the property could be sold at a profit. After the properties were purchased, the perpetrators severed all contact with the investors, who then discovered that the purchase price was substantially above market value, that properties had not been rehabbed (or that only cosmetic repairs had been made and that the value of the work was inflated), that the properties could not be rented at an amount sufficient to service the mortgage, much less for a monthly profit, and that the property could not be sold for what was owed on the mortgage. These novice investors also report that they believed the perpetrator's claims because they had watched A&E's "Flip This House" program and/or the Carleton Sheets "no money down, cash back at closing" infomercials, which gave them the impression that real estate investing was both easy and profitable, and which made the schemes proposed by the perpetrators seem both legal and credible.

<sup>21</sup> 18 U.S.C. § 1344.

<sup>22</sup> 18 U.S.C. § 1341.

<sup>23</sup> 18 U.S.C. § 1343.

<sup>24</sup> 18 U.S.C. § 1349.

<sup>25</sup> 18 U.S.C. § 1956 and 18 U.S.C. § 1957.

<sup>26</sup> 18 U.S.C. § 1028(A).

<sup>27</sup> 18 U.S.C. § 157 and 18 U.S.C. § 152 (concealment of assets and false oaths to a trustee).

<sup>28</sup> 18 U.S.C. § 1005 (false entries, reports and transactions) and 18 U.S.C. § 1014 (false reports and financial statements).

<sup>29</sup> See, e.g., O.C.G.A. § 8-16-102. Enacted in 2005 and known as the Georgia Residential Mortgage Fraud Act, it was the first state or federal statute to specifically define and criminalize mortgage fraud. It is a RICO predicate and carries a sentence of up to twenty years imprisonment. Since then, a number of states have passed laws criminalizing mortgage fraud, including: Arizona (Ariz. Rev. Stat. § 13-2320), Colorado (Colo. Rev. Stat. § 24-76-103), Florida (Fl. Stat. Ann. § 817.545), Maryland (Md. Code Ann., Mortgages, § 7-402), Minnesota (Minn. Stat. Ann. § 609.822), Mississippi, (Miss. Code Ann. § 97-23-107), Nevada (Nev. Rev. Stat. § 205.372), North Carolina (N.C. Gen. Stat. Ann. § 14-118.10 et seq.), and Texas (Tex. Code Ann. § 402.032). California joined these states in 2009, but the maximum sentence under its statute is only 1 year. Cal. Penal Code § 532f(h).

<sup>30</sup> Common schemes include: the use of "straw" (or nominee) buyers, mischaracterization of the intended use of the property (owner-occupied or second home instead of investment), undisclosed seller contributions to the borrower's down

The object in a fraud-for-profit scheme is to obtain residential mortgage loan proceeds and/or physical and legal control of residential properties. Lenders and law enforcement agencies have traditionally focused on for-profit schemes because they involve organized rings, industry insiders,<sup>31</sup> multiple properties,<sup>32</sup> and millions of dollars in losses.

In fraud for-housing schemes, the object is to obtain a loan that would have been made on materially different terms, or would not have been made at all, had the lender known the truth.<sup>33</sup> Fraud-for-housing schemes have largely been ignored because of the industry belief that they involved a small percentage of individual borrowers who were merely “stretching” to buy a home which they intended to pay for and, until the “mortgage meltdown,” there weren’t a lot of these cases and the majority of these loans *were* repaid. But by tolerating fraud-for-housing, the line between acceptable and illegal practices was blurred, fraud of all types was tacitly encouraged<sup>34</sup> and millions of fraudulent loans were made.

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payment (borrowers with little financial investment are at higher risk of default), undisclosed or fictional second mortgages from the seller (lender unknowingly extends 100 percent financing), “buy and bail” (underwater borrower buys comparable property nearby and lets mortgage on old residence go into default and foreclosure), builder and developer bailouts (straw buyers and undisclosed seller concessions, which inflate the sales price, are used to unload excess inventory), flipping (perpetrators collude with real estate agents and/or appraisers to fraudulently inflate the sale price in a rising market), flopping (real estate agents and investors collude to *deflate* the short sale price in a declining market before flipping flip it at an inflated value to co-conspirators or straw buyers), modification fraud (borrowers understate their income and property value in hopes of getting a debt reduction), forced modifications (distressed borrowers sell the property to family members, friends, or a corporation owned by the borrower and the property is re-conveyed to the borrower), deed or title theft (deeds of conveyance and satisfaction are forged and perpetrators sell the property to a straw buyer who obtains a mortgage with 100 percent of the proceeds going to the perpetrator), and settlement agent fraud (escrow or settlement agent absconds with loan proceeds instead of paying off existing liens and mortgages).

<sup>31</sup> Federal Bureau of Investigation, “Financial Crimes Report to the Public,” May 2005.

[http://www.fbi.gov/publications/financial/fcs\\_report052005/fcs\\_report052005.htm#d1](http://www.fbi.gov/publications/financial/fcs_report052005/fcs_report052005.htm#d1) (accessed March 6, 2009).

<sup>32</sup> See, e.g., *U.S. v. Alcindor, et. al.*, 1:05-CR-0269 superseding indictment (N.D. Ga., 2005) (orchestrator Phil Hill convicted in case involving 234 single family houses, condominiums and mobile homes) and *U.S. v. McFarland*, 1:04-CR-224, superseding indictment (N.D. Ga., 2004) (McFarland, a closing attorney, was convicted on a 165 count indictment involving 85 properties).

<sup>33</sup> Material terms include: loan amount, interest rate, and the size of the borrower’s down payment. Misrepresentations relating to a borrower’s income and employment, source and amount of the down payment, the seller’s contribution to the borrower’s settlement costs, the borrower’s intent with respect to occupancy, and the value of the collateral property are used to mask increase the borrower’s apparent creditworthiness in order to induce the lender to grant the loan and on terms more favorable to the borrower, i.e., at a lower interest rate, a lower down payment, and/or with a waiver of mortgage insurance.

<sup>34</sup> There are numerous instances of borrowers who report that they were told by a mortgage professional to lie about their income and were told that was acceptable because so long as they repaid the mortgage the lender wouldn’t care. One effect of the industry’s attitude is found in what became a common practice among otherwise honest real estate agents: raising the contract purchase price to disguise a seller’s contribution to the borrower’s down payment. The agents justified their conduct as “taking a little from column ‘A’ and putting it in column ‘B’” in a “net-net” transaction that would

## The Scope of Mortgage Fraud

As early as 2004 the Federal Bureau of Investigation was characterizing mortgage fraud as “pervasive and growing.”<sup>35</sup> Chris Swecker, the FBI’s then-Assistant Director of the Criminal Division, testified to Congress that:

“Mortgage fraud losses adversely affect loan loss reserves, profits, liquidity levels and capitalization ratios, ultimately affecting the soundness of the financial institution. [I]f fraudulent practices become systemic within the mortgage industry and mortgage fraud is allowed to become unrestrained, it will ultimately place financial institutions [and the stock market] at risk... [i]nvestors may lose faith and require higher returns from mortgage backed securities [and that] may...result in higher interest rates and fees paid by borrowers and limit the amount of investment funds available for mortgage loans.<sup>36</sup>..... “

That statement was as prescient as it was unheeded and short of the mark. As the FBI’s Deputy Director testified on March 20, 2009, what has occurred is “far worse” than what even Mr. Swecker imagined.<sup>37</sup> Mortgage fraud is now at epidemic levels and is placing significant strains on the Bureau’s resources.<sup>38</sup> The FBI’s caseload has expanded to over 2,000 active cases, including 43 corporate fraud cases relating directly to the financial crisis and 200 new investigations in the first quarter of 2009 alone.<sup>39</sup>

The torrent will not abate any time soon: the number of mortgage fraud-related suspicious activity reports (“SARs”) reports filed with the Crimes Enforcement Network

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allow the deal to close with no harm being done to anyone. From a lender’s perspective the transaction was fraudulent because the risk of default posed by the borrower was understated (the less a borrower invests, the more likely he is to default), and the loan-to-value ratios were skewed. When large numbers of loans like this were pooled, the misrepresentations continued on to the ratings agencies and investors because the fact that these loans did not meet investor guidelines was obscured by the structure of the underlying mortgage transactions.

<sup>35</sup> Statement of Assistant Director Chris Swecker before the House Financial Services Subcommittee on Housing and Community Opportunity, October 7, 2004. <http://www.fbi.gov/congress/congress04/swecker100704.htm> (accessed March 29, 2009).

<sup>36</sup> *Id.*

<sup>37</sup> Statement of Deputy Director John S. Pistole before the House Financial Services Committee, March 20, 2009. <http://www.fbi.gov/congress/congress09/pistole032009.htm> (accessed March 29, 2009).

<sup>38</sup> *Id.*

<sup>39</sup> Brent Kendall, “FBI Ramps Up Probes of Financial, Mortgage Fraud,” *The Wall Street Journal*, March 20, 2009. <http://online.wsj.com/article/SB123756681453396825.html> (accessed March 24, 2009). The FBI reported a total of 1,204 open mortgage fraud cases at end of FY 2007, a 47 percent increase over FY 2006 and a 176 percent increase from FY 2003. Federal Bureau of Investigation, “2007 Mortgage Fraud Report,” April 2008. [http://www.fbi.gov/publications/fraud/mortgage\\_fraud07.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud07.htm) (accessed March 8, 2009). The case load increased to 1,644 by February 2009. FBI, “Mortgage Fraud”. [http://www.fbi.gov/hq/mortgage\\_fraud.htm](http://www.fbi.gov/hq/mortgage_fraud.htm) (accessed March 8, 2009).

(“FinCEN”) rose 1,411 percent between 1997 and 2005,<sup>40</sup> and by double digits each year between 2002 and the present.<sup>41</sup> FinCEN received over 63,000 mortgage-related SARs in fiscal year 2008 and an additional 28,000 reports in the first five months of fiscal year 2009.<sup>42</sup>

The sobering reality is that the figures cited above capture only the tip of the iceberg. We can only guess at the true scope of fraud because the majority of entities with relevant information relating to mortgage fraud activities are not required to file SARs.<sup>43</sup> There is no “safe harbor” to protect voluntary reporters against civil or criminal actions for libel, slander, or unauthorized disclosure of confidential information relating to mortgage transactions and borrowers.<sup>44</sup> A large number of lenders whose victimization is just now surfacing have closed their doors or gone bankrupt so there is no one to report it to authorities, and the substantial adverse financial consequences for fraudulently originated loans discourage lenders from investigating and reporting fraud.<sup>45</sup> It is, literally, the “F” word of the financial services industry and may not be spoken of in polite banking company.

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<sup>40</sup> Financial Crimes Enforcement Network, “Mortgage Loan Fraud: An Industry Assessment Based on Suspicious Activity Report Analysis,” November 2006, p 4. [http://www.fincen.gov/news\\_room/rp/reports/pdf/MortgageLoanFraud.pdf](http://www.fincen.gov/news_room/rp/reports/pdf/MortgageLoanFraud.pdf) (accessed March 8, 2009).

<sup>41</sup> FinCEN reported a 33 percent increase between 2002 and 2003 and a 92 percent increase between 2003 and 2004. *Id.* The most recent report shows an increase of 44 percent between 2005 and 2006, and an additional 37 percent increase between Q1 2006 and Q1 2007. FinCEN, “Mortgage Loan Fraud: An Update of Trends based upon an Analysis of Suspicious Activity Reports,” April 2008 at 21.

[http://www.fincen.gov/news\\_room/rp/files/MortgageLoanFraudSARAssessment.pdf](http://www.fincen.gov/news_room/rp/files/MortgageLoanFraudSARAssessment.pdf) (accessed March 8, 2009).

<sup>42</sup> Testimony of Deputy Director John S. Pistole to the House Financial Services Committee, March 20, 2009.

<http://www.fbi.gov/congress/congress09/pistole032009.htm> (accessed March 29, 2009). FinCEN is on track to receive more than 70,000 reports in FY 2009. FBI, “2008 Mortgage Fraud Report ‘Year in Review,’” June 2009.

<sup>43</sup> Only “financial institutions” as defined in 31 U.S.C. § 5312(a)(2) (primarily federally regulated and insured banks and thrifts, credit unions, life and annuity insurers, and cash-based business such as pawnshops and casinos) are required to file Suspicious Activity Reports with the Financial Crimes Enforcement Network because this statute’s focus is money laundering.

<sup>44</sup> Other potential sources of useful information relating to mortgage fraud include mortgage and title insurance companies, due diligence providers, and investors in the secondary market.

<sup>45</sup> These disincentives include financial risk (repurchase of fraudulent loans, increased loan loss reserve requirements for portfolio loans, and denial of mortgage and title insurance claims). Lenders also face reputational risk and potential negative shareholder actions.

## The Economic Cost to Lenders

While a comprehensive loss figure is impossible to obtain, we do know that fraud in residential mortgages is very expensive to lenders. An analysis of two million closed loans revealed that loans originated in fraud are eight times more likely to default, and 20 times more likely to enter into the foreclosure process, within the first year of origination.<sup>46</sup> The loss severity to lenders from foreclosures due to “natural” events<sup>47</sup> has historically ranged from 15 to 40 percent of the original mortgage amount, depending on the length of time that elapses between origination and default, and, until the mortgage meltdown and economic collapse, hovered at an average of approximately \$30,000 per loan. In contrast, losses from foreclosures on fraudulently originated loans range conservatively from 40 to nearly 100 percent, depending on the type of scheme, the time lapse between origination and default, and the amount by which the mortgage was inflated.<sup>48</sup> Average loss amounts today are rising because the damage caused by collateral value inflation at origination is being compounded by severely depreciating real estate market values.

Here’s what we do know about the cost of fraud:

- The FBI estimates fraud’s dollar cost from the amounts reported in SARs. Although that figure stood at \$1.5 billion during fiscal year 2008, the FBI acknowledges that 93 percent of the reports it received failed to indicate a specific dollar loss.<sup>49</sup>

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<sup>46</sup> Derek Stanford, PhD., “2007 Risk Metrics Validation Study.” <http://interthinx.com/pdf/RiskMetricValStudy.pdf> (accessed March 25, 2009). See also BasePoint Analytics press release, February 12, 2007 (fraud accounts for up to 70% of all early payment defaults).

<sup>47</sup> “Natural” or “conventional” foreclosures occur primarily because of death, divorce, job loss and unexpected medical expenses.

<sup>48</sup> Investigation of fraudulent mortgage loans show that loss severity ratios approach 100 percent in cases involving “air loans” (no building on the secured property) and “double sold” note schemes (one mortgage note is sold to multiple investors simultaneously; since only the first sale is recorded, the other investors’ interest is not recorded and thus is unsecured).

<sup>49</sup> Testimony of Deputy Director John S. Pistole to the House Financial Services Committee, March 20, 2009. <http://www.fbi.gov/congress/congress09/pistole032009.htm> (accessed March 29, 2009). This omission may be due, in

- When measured by the loss claimed by lenders in civil and criminal prosecutions, the figure stood at \$5.4 billion at the end of 2008, with an additional \$3.1 billion reported in the first half of 2009.<sup>50</sup> Lawsuits provide an incomplete measure of the cost because fraud investigations and prosecutions are extremely resource intensive and produce little perceived return on investment.<sup>51</sup> Cash-strapped lenders and overwhelmed federal prosecutors are unwilling to pursue any but the largest cases.<sup>52</sup>
- Rather than being a relatively uncommon and harmless form of fraud that could safely be ignored,<sup>53</sup> it is increasingly clear that the incidence of fraud-for-housing was extensive:
  - Quality control audits and post-foreclosure fraud investigations indicate that as much as 60 percent of all Alt-A originations through 2008 contained material misrepresentations of the borrower's income, employment, assets, and/or collateral value, representing a potential aggregate loss of \$218 billion.
  - QC audits and investigations also reveal that as much as 50 percent of conforming<sup>54</sup> loan originations from 2007 and 2008 failed to meet

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part, to lender confusion about when to state a dollar loss. While bank regulators instruct lenders to omit a dollar loss unless an actual loss has been realized, the FBI cannot judge the relative size and importance of the case or determine whether it meets prosecutorial thresholds when the amount is not stated. Without this critical information, these SARs receive a low investigative priority and the perpetrators are free to ply their trade unhindered for additional years.

<sup>50</sup> MortgageDaily.com "FraudBlogger Index." <http://www.fraudblogger.com/FraudIndex.asp> (accessed March 8, 2009).

<sup>51</sup> Disincentives include: 1) the judiciary's view of mortgage fraud as a victimless financial crime and the imposition of relatively light sentences, *see, e.g., U.S. v Trester*, 1:05-CR-00086 (S.D. Ohio 2005) (maximum sentence in "flipping" case involving 800 residential properties and severe damage to neighborhoods was forty-six months); 2) the lender's expense for providing copies of documents and making personnel available to work with law enforcement and travel to and testify at trial, and c) the likelihood that restitution will not be made because the defendants either spent or hid the illicit proceeds and do not have the means to generate the legitimate income necessary to meet a restitution order that may total several million dollars.

<sup>52</sup> While the author knows of no *per se* loss thresholds for bank fraud cases apart from those required to confer jurisdiction, United States Attorneys generally will not open a case unless the aggregate loss exceeds \$1 million. This approach is more reasonable than it might initially appear because: a) the number of potential cases are virtually limitless; b) mortgage fraud cases are increasingly difficult to prove because the bankruptcy, failure, and consolidation of lending entities has made critical witnesses and documentation inaccessible; and c) because of the perceived difficulty, except in the most egregious cases, of overcoming public hostility towards mortgage lenders and their lending standards and practices.

<sup>53</sup> Some experts argued that loans in fraud-for-housing cases posed only "technical compliance issues" and posed little risk to lenders because they "never default." *See, e.g.,* First American CoreLogic. "Mark Fleming on Fraud Prevention," *Mortgage Banking*, August 2005. [https://www.corelogic.com/documents/20050801\\_Mortgage\\_Banking\\_Interview.pdf](https://www.corelogic.com/documents/20050801_Mortgage_Banking_Interview.pdf) (accessed March 6, 2009).



underwriting guidelines relating to the borrower's income, employment, assets and/or collateral value, putting Freddie Mac and Fannie Mae at risk of losing as much as \$500 billion.

- Mark Zandi, Chief Economist for Moody's Economy.com, calculates that the fallout from 15 million "sketchy" loans made between mid-2004 and mid-2007 will cost the U.S. financial system \$625 billion.<sup>55</sup>

As staggering as these figures are, they are still likely to be low because mortgage fraud didn't stop in mid-2007 when the financial markets collapsed. It got worse and, after a slight lull in 2008, fraud risk indicators appear to be poised for a rebound in 2009 and beyond.<sup>56</sup>

- An analysis of loans originated between July 1 and December 31, 2007, after underwriting guidelines were tightened in the wake of the mortgage meltdown, found critical fraud risk indicators pointing to significant inflation of the borrower's income in more than 42,000 mortgage applications representing \$11 billion in potential loans.<sup>57</sup> Recognizing the threat posed by borrowers who misrepresent their income, many lenders now verify borrower income directly with the Internal Revenue Service, but investigations show that an increasing number of borrowers today are filing returns that fraudulently overstate taxable income in order to qualify for a purchase mortgage, to refinance an existing loan or to obtain a mortgage modification under

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<sup>54</sup> A conforming loan is a loan that is eligible for purchase by Freddie Mac and Fannie Mae. The maximum eligible loan amount was less than \$417,000 for much of the boom years, but was raised to \$625,500 in high-cost areas in mid-2008 pursuant to the Housing and Economic Recovery Act of 2008. The maximum amount is \$938,250 in Alaska, Hawaii, Guam and the US Virgin Islands. Fannie Mae, "Loan Limits for Conventional Mortgages."

<https://www.efanniemae.com/sf/refmaterials/loanlimits/>

<sup>55</sup> Mark Zandi, "When Will It End," Moody's Economy.com Regional Financial Review, at 15 (September 2008). <http://www.economy.com/mark-zandi/documents/When-Will-It-End.pdf> (accessed March 8, 2009).

<sup>56</sup> Intethinx, Q2 and Q3 2009 Mortgage Fraud Risk Reports. [http://www.intethinx.com/pdf/09\\_Q2MFRI\\_FNL.pdf](http://www.intethinx.com/pdf/09_Q2MFRI_FNL.pdf) and [http://www.intethinx.com/pdf/09\\_Q3MFRI\\_FNL.pdf](http://www.intethinx.com/pdf/09_Q3MFRI_FNL.pdf) (accessed January 4, 2010). Intethinx is a leading provider of fraud and compliance risk management systems for the residential mortgage lending industry.

<sup>57</sup> Intethinx press release, March 13, 2008. [http://intethinx.com/press/FraudBytes\\_042808/](http://intethinx.com/press/FraudBytes_042808/) (accessed March 24, 2009).

the federal Hope for Homeowners and Making Home Affordable programs. The returns are amended to reflect the borrower's true income after the loan is closed.

- Freddie Mac executives have said publicly that loans originated in 2008 were the “worst in history,” with an alarming number of those loans completing the foreclosure process less than one year from origination.<sup>58</sup> This suggests an explanation for the sharp rise in first- and early-payment defaults, both of which are closely correlated with fraud in the origination of the mortgage.<sup>59</sup>
- Many of the lenders and brokers in the subprime space who were displaced during the collapse of the residential mortgage industry have formed new companies and are obtaining FHA Direct Endorsement authority, despite their histories of bankruptcies, criminal convictions, and sanctioning by state regulators.<sup>60</sup> There is a clear correlation between mortgage fraud and non-bank/brokered originations,<sup>61</sup> and this “subprime creep” may be responsible for the alarming increase in first-payment defaults – a sure sign of fraud -- in FHA-insured loans originated in 2008.<sup>62</sup>
- Lenders who perform QC audits on current originations which have been approved by TOTAL Scorecard, the FHA's automated underwriting system (“AUS”),<sup>63</sup> are privately reporting that 60 percent of these loans contain obvious indications of fraud.

This may provide further evidence of subprime creep, but it is also evidence that too

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<sup>58</sup> Various Freddie Mac representatives at Mortgage Bankers conferences in 2008.

<sup>59</sup> A first payment or “instant” default is defined as a loan that goes into default without a single payment being made. An early payment default (EPD) is generally defined as a loan that goes into default within 90 to 180 days after origination. A study by BasePoint Analytics in 2007 found that up to 70 percent of all EPDs were originated in fraud. BasePoint Analytics press release, February 12, 2007.

<sup>60</sup> Chad Terhune and Robert Berner, “FHA-Backed Loans: The New Subprime,” *BusinessWeek*, November 19, 2008. [http://www.businessweek.com/magazine/content/08\\_48/b4110036448352.htm?chan=top+news\\_top+news+index+-+temp\\_top+story](http://www.businessweek.com/magazine/content/08_48/b4110036448352.htm?chan=top+news_top+news+index+-+temp_top+story) (accessed March 27, 2009).

<sup>61</sup> A one unit increase in non-bank originations within a given census tract increases, by a factor of 4.8, the likelihood that the tract contains mortgage fraud. Cary Collins, Ann Fulmer, Keith Harvey and Peter Nigro, “Mortgage Fraud's Impact on Housing Markets: An Atlanta Case Study in Neighborhood Collateral Damage,” 2009 (working paper).

<sup>62</sup> Dina ElBoghady and Dan Keating, “The Next Hit: Quick Defaults,” *Washington Post*, March 8 2009.

<http://www.washingtonpost.com/wpdyn/content/article/2009/03/07/AR2009030702257.html> (accessed March 25, 2009).

<sup>63</sup> For an explanation of what the FHA system does and does not do, and what elements of an application are evaluated, see [http://www.hud.gov/offices/hsg/sfh/lender/total\\_faqs.pdf](http://www.hud.gov/offices/hsg/sfh/lender/total_faqs.pdf) (accessed January 4, 2010).

many underwriters are relying on automated underwriting tools as a substitute for due diligence and critical analysis. The FHA tool, like those of Fannie Mae<sup>64</sup> and Freddie Mac, has a limited function: to examine loan characteristics such as the loan-to-value and debt-to-income ratios and determine whether the loan will meet eligibility guidelines for insurance (FHA) or purchase (Fannie and Freddie). The problem is that the borrower's qualifications and loan characteristics can be fabricated or misrepresented. Automated underwriting tools passively accept the information submitted on the application and thus are unable to detect fraud. During the boom -- and even today -- many loan originators used the AUSs as decisioning tools without subjecting the underlying data to verification,<sup>65</sup> which has exposed the GSEs and the FHA to significant levels of fraud risk.

- FBI field agents report an increase in fraud relating to low-income HUD housing grants and are expecting to see more as Neighborhood Stabilization Program funds begin to be disbursed. The stabilization programs will provide a bonanza for the career fraudsters, who no doubt are already positioned to take advantage of the opportunity to snap up federally-subsidized bargains in foreclosed housing stock that will eventually be recycled into new fraud schemes.
- Wholesale flipping, where foreclosed properties are purchased in bulk then sold to investors who flip the property to "end buyers" are on the rise, fueled by the bloated

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<sup>64</sup> Fannie Mae's AUS is known as "Desktop Underwriter," which is a misnomer because it doesn't perform critical underwriting functions. Sound underwriting practices require verification of application data, scrutiny for patterns and red flags that indicate fraud, and critical analysis to ensure that the loan "makes sense" given the borrower's financial profile and stated use. The process can be very time consuming if performed manually and speed was one of the selling points to the industry when this product was rolled out. For an illuminating article on Fannie's system, see Michael D. Larson, "Secrets of the Automated Underwriting System Revealed at Last," Bankrate.com (February 3, 2000). <http://www.bankrate.com/brm/news/mtg/20000203.asp> (accessed January 4, 2010). Freddie Mac's AUS is known as "Loan Prospector."

<sup>65</sup> Many lenders feel that they do not need to use automated fraud detection technology because they now require full documentation in support of the application. These lenders ignore the fact that desk-top technology allows for the fabrication or forgery of every document needed to support an application and close the loan. .

inventory of foreclosed properties held by the FDIC and banks. Although these properties can be purchased for literally pennies on the dollar, many are seriously dilapidated, or uninhabitable, and the price to the end buyer (often an investor) is illegally inflated.

- Short sale flipping, where the price is fraudulently *deflated* in order to generate the “profit” on the sale to the end-buyer is also on the rise. These transactions frequently are presented to the distressed borrower as a way to avoid foreclosure, and are marketed to the end buyers as the ultimate in “get rich quick” investment programs.
- Another area of major growth for fraud is in reverse mortgages. FHA-insured Home Equity Conversion Mortgages (“HECMs”), available only to those who are 62 years old or older, do not now account for a large share of the market, but they will: the total number of persons aged 65 or older will surpass 88 million by 2050.<sup>66</sup> Since nearly 80% of seniors own their homes, this demographic represents trillions of dollars in untapped home equity.<sup>67</sup> With that kind of money in play, and with HUD’s decision to allow HECM funds to be used for purchases, we should not be surprised that the fraudsters are already moving into this space: a title insurance company recently reported privately that the developer of a failed condo conversion project<sup>68</sup> in Florida, working in collusion with a loan officer, an appraiser and a settlement agent, recruited immigrant seniors, recorded deeds of conveyance and sham purchase money mortgages and obtained HECM loans for the seniors at inflated values. The

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<sup>66</sup> Press release, U.S. Census Bureau, August 14, 2008. <http://www.census.gov/Press-Release/www/releases/archives/population/012496.html> (accessed July 2, 2009).

<sup>67</sup> Donald L. Redfoot, Ken Scholen and S. Kathi Brown, “Reverse Mortgages: Niche Product or Mainstream Solution,” December, 2007. [http://assets.aarp.org/rgcenter/consume/2007\\_22\\_rev mortgage.pdf](http://assets.aarp.org/rgcenter/consume/2007_22_rev mortgage.pdf) (accessed July 2, 2009).

<sup>68</sup> Condo conversion projects in many instances represent flipping on steroids (instead of flipping one property at a time, fraudsters purchased entire apartment complexes and flipped hundreds of units in a short period of time). Condo conversions are so toxic that mortgage insurance giant Radian recently announced it would no longer insure ANY attached condominiums. Radian Guaranty e-Bulletin 2009-01, p. 2, March 10, 2009. [http://radian.biz/pdf/Radian\\_eBulletin\\_2009-01.pdf](http://radian.biz/pdf/Radian_eBulletin_2009-01.pdf) (accessed March 29, 2009).

developer got out from under his debt obligations and made a profit, but many of the seniors were impoverished and had no funds for furniture, utility service or even groceries, much less the homeowner association dues needed for maintenance or to pay property taxes. When these mortgagors eventually default,<sup>69</sup> U.S. taxpayers will have to pick up the tab.

### **Potemkin Villages: Fraud's Collateral Damage to Communities and Local Governments**

Mortgage fraud is not a victimless financial crime. A fraudulently acquired home sets off a long-lasting spiral of ever-widening destruction, regardless of whether it's in the urban core or in the most exclusive suburbs, in a poor neighborhood or a rich one. If the home is acquired in an organized for-profit or investment scheme, it is likely to remain vacant and untended. These properties are pillaged by the perpetrators, and later vagrants, who strip them of appliances, heating and air conditioning systems, doors and fixtures, copper plumbing and wiring.

Abandoned and derelict properties eventually attract squatters,<sup>70</sup> even in houses that last sold for half a million dollars or more. In the winter, the squatters light fires to stay warm. When they overload the fireplace, or start them on the floor because there is no fireplace, the house burns down. The fraudsters, keeping watch from a distance, may file a property insurance claim and immediately get a check for thousands of dollars for temporary living expenses.<sup>71</sup>

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<sup>69</sup> Default events include failure to maintain the property and failure to pay property taxes.

<sup>70</sup> See, e.g., Jonathan Mummolo and Bill Brubaker, "As Foreclosed Homes Empty, Crime Arrives," *Washington Post*, April 27, 2008. <http://www.washingtonpost.com/wp-dyn/content/article/2008/04/26/AR2008042601288.html> (accessed January 5, 2010). There are organized efforts in some cities that encourage squatting as a means to extract revenge on lenders. See, e.g., Squat 2 Own, <http://www.squat2own.com/>, and John Leland, "With Advocates' Help, Squatters Call Foreclosures Home," *The New York Times*, April 9, 2009. <http://www.nytimes.com/2009/04/10/us/10squatter.html> (accessed January 5, 2010).

<sup>71</sup> See, e.g., *U.S. v. Jackson*, 1:02-CR-00030 (N.D. Ga. 2002) (defendant stole sister's identity to complete fraudulent purchase of a home which burned and was declared uninhabitable; Jackson used the assumed identity in an attempt to obtain casualty insurance proceeds).

The insurers and the county will inspect what's left of the structure. If the structure is severely damaged the county will order the owner to secure and repair or raze the house. If the fraudsters used a stolen identity the county will not be able to complete service of the notice because the "owner" is fictitious. If the lender refuses to foreclose, it is not legally responsible for the physical condition of the property and it may enter into a legal limbo and linger as a dangerous eyesore for years. If the neighbors are persistent, the county may eventually raze the structure, but the damage to the community will not be erased when the ruin is finally removed. If the structure is a total loss and the state has a "valued policy" law which requires payment of the face value of the policy, the insurer will be forced to pay inflated claims for structural and personal property losses, resulting in an additional economic windfall to the fraudsters and a larger loss to the insurer.

If the fraudsters are sophisticated enough to know that they need to avoid an early payment default, which would provoke the lender into scrutinizing the mortgage transaction and lead to discovery of the fraud, the home may be rented,<sup>72</sup> turned into an assisted living facility, or used as a half-way house for convicted felons re-entering society. In upscale neighborhoods, the perpetrators and their criminal associates – check kites, assault and batterers, burglars, fugitives, pimps, money launderers and drug traffickers– may move in and begin conducting "business" from their homes. These are not "day" people, nor are they much concerned with yard work or maintenance, so it's not long before even the casual observer can see the physical neglect and discern that there's something wrong. Obviously deteriorating properties ruin the "curb appeal" of the neighborhood and, since home purchases are motivated in part by an emotional

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<sup>72</sup> Investigations reveal that Section 8 HUD housing vouchers are sometimes used to obtain renters. In those cases the government is subsidizing the fraudsters directly.

resonance with the house and the neighborhood, potential buyers decide to look elsewhere and sales prices begin to stagnate.

Fraud tends to cluster geographically because once the first fraudulently inflated sales price is recorded in the deed, realtor, commercial appraisal and tax databases, it can be referenced as a comparable sale to support an artificially inflated appraisal for other nearby properties.<sup>73</sup> Thus a single problem property quickly mushrooms into multiple problem properties. (Figure 1) Even in upscale neighborhoods it's not long before the accumulating weight of vacant and neglected properties makes the area look blighted.<sup>74</sup> (Figure 2).

By this point the original residents, justifiably concerned about their safety and the value of their homes, begin to flee. Multiple vacancies and properties on the market indicate an unstable and declining neighborhood, which drives away more potential buyers, and asking prices begin to drop significantly. The perpetrators may play on the owners' fears to drive hard bargains and may threaten sellers if their offers are rejected.<sup>75</sup> When reputable real estate agents begin to sense that something peculiar is going on they, too, begin to flee the neighborhood because they rely on repeat business and referrals and

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<sup>73</sup> One of the oldest tricks in the fraud book is to offer inexperienced or corrupt appraisers a ready-made list of "comparable" properties to help them in their evaluation. In reality these "comparables" are properties in the vicinity that were flipped by the perpetrators. When they're accepted without question or investigation, fraudsters can drive the market.

<sup>74</sup> Kevin Wiggins, a now-convicted mortgage fraudster, fraudulently "flipped" five houses in one section of Atlanta's 30310 zip code in 2000. By 2008, he had flipped eighty-three more houses, all within a five mile radius. One street, Lucile Avenue, was particularly hard-hit: 18 houses were owner-occupied when Wiggins flipped two of them in 2000; other fraud rings moved in after Wiggins' initial purchase and by 2008, 18 houses had been flipped, 15 of the flipped houses were vacant and only 3 houses were owner-occupied. Flipping continues on this street today. Several homes that were "sold" in 2007 and 2008 from the high \$200s to over \$400,000 have already been foreclosed. Post-foreclosure asking prices as of March 27, 2009, range from \$18,905 to \$99,000.

<sup>75</sup> Residents of fraud-inflicted neighborhoods in Atlanta have reported that they were threatened with Fair Housing complaints for questioning offers from potential buyers, who never set foot in the house, for as much as \$200,000 above the asking price on condition that the seller kickback the "excess" to the buyer at or after closing. In an incident in Omaha, Nebraska, according to local residents, the homeowner's association was threatened with a Fair Housing complaint for attempting to enforce subdivision regulations against tenants and owners whose homes had been procured through alleged fraud. (For fraud related charges, see U.S. v. Williams, 8:09-CR-245 (D. Neb. 2009)). Residents of neighborhoods impacted by an alleged fraud ring in Dallas, Texas, who filed civil nuisance suits against the ring-leader, were counter-sued for \$5 million for alleged harassment and racial bias. Tim Wyatt, "Neighbors Suspect Scam in Home Sales," *Dallas Morning News*, December 17, 2005; <http://www.dallasnews.com/sharedcontent/dws/dn/latestnews/stories/121805dnmetloanwar.2bb6980.html> (accessed July 2, 2009); for fraud related charges, see U.S. v. Farrington, 3:08-CR-00153 (N.D. Texas, 2008).

do not want to lose potential customers by putting them into a troubled neighborhood. That leaves the field open for more fraud because the only agents who are able to close any sales are the ones who work in collusion with the perpetrators. Since these agents, are the only ones able to close any sales, frequently through the use of “creative financing,” they begin to pick up the new listings. When that happens, the fraudsters control the market and gain the ability to drive pricing in the broader neighborhood market.

In the year or so before the wave of foreclosures begins, the quality of life for the remaining residents deteriorates substantially. Regardless of the relative poverty or affluence of the neighborhood, crime increases. More vacant homes pop up bringing weedy, overgrown lots, vandalism or gang graffiti “tags.” If the properties are occupied, the police are called upon to intervene in a rising tide of crime. Some crimes, like public intoxication and prostitution, are a nuisance and an offense to the community’s moral values.<sup>76</sup> Some, like mail theft and auto break-ins, are relatively petty. But some, like gunfights, drug trafficking, and the conversion of McMansions into hydroponic marijuana farms, meth labs, and stash houses, are deadly serious. The criminal invasion robs the neighbors’ of their sense of safety and security, sparking additional flight and destabilization and a further erosion of property values.

As the quality of life decays for the remaining law-abiding citizens, tax assessors add insult to injury by raising property tax assessments. County appraisers are rarely trained to recognize fraudulent transactions. While they may exclude the first few sales as outliers, additional sales at fraudulently inflated prices create the appearance that the

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<sup>76</sup>Dan Immergluck and Geoff Smith. 2006. The impact of single-family mortgage foreclosures on neighborhood crime. *Housing Studies* 21(6): 851-66.



appreciation is the result of legitimate market forces. Inflated values are accepted as legitimate market values, and fraud begins to corrupt the tax digests. (Figure 3) When a critical mass of sales is reached the neighborhoods are re-assessed. If the county appraisers fail to recognize the fraudulently inflated sales prices, the reassessment values will be inflated --- by as much as 30 percent--- in the impacted neighborhood and within a radius of several miles.<sup>77</sup> This can occur even though property values are actually falling.<sup>78</sup> Thus these neighborhoods become Potemkin Villages: their rising prosperity is a façade that exists only on paper.

Fraud's inflationary effect on property tax assessments is pernicious and far reaching.<sup>79</sup> When a foreclosure occurs due to a natural life-event such as job loss, death of a spouse, or divorce, every house within a one-eighth mile radius suffers a 1 percent drop in value.,<sup>80</sup> The geographic clustering of foreclosures, which is common in mortgage fraud cases, amplifies that drop: if there are five such properties on the same street, the value of all homes within that radius will decline by 5 percent when they are eventually foreclosed.<sup>81</sup> But even when the majority of sales are foreclosures, assessed tax values may, paradoxically, remain constant or even increase. This is because county appraisers are generally required to consider only sales that occur at fair market value.

“Fair market value” is generally defined as the amount that a buyer is willing to pay, and

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<sup>77</sup> Tax officials in Boulder County, Colorado, reported tax assessment inflation up to six miles away from the affected neighborhoods. “Price Was Not Right,” American City & County, December 1, 2009. <http://americancityandcounty.com/technology/mortgage-fraud-gis-analysis-200912/index.html> (accessed January 11, 2010).

<sup>78</sup> In the 30310 zip code in metropolitan Atlanta, which has been at the top of national fraud lists for several years, residents are being overcharged on property taxes by an estimated \$10.36 million. Kevin Duffy, “Study: Poor Neighborhoods Face Unfair Property Taxes,” *The Atlanta Journal-Constitution*, October 9, 2008.

<sup>79</sup> The growth in assessed values in fraud neighborhoods was significantly higher over the full eight year time span studied. Andrew T. Carswell, “Effects of Mortgage Fraud on Property Tax Assessments”, *Journal of Property Tax Assessment and Administration* (2009, in press).

<sup>80</sup> Dan Immergluck and Geoff Smith, “There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values,” p. 9, Woodstock Institute, June 2005.

<sup>81</sup> Interview with Dan Immergluck, Atlanta, Georgia, 2007.

a seller will accept, in an arms-length transaction. Foreclosures are excluded because they are distress sales and the “price” is set by the mortgage balance, not market forces.

When the lender in possession re-sells the property, the price is usually at a discount to the market because the lender needs to move the property quickly and the house most likely needs repairs, so the assessors disregard these sales as well. But because the mortgages were inflated through fraud, even the foreclosure prices are above market value. In hard-hit neighborhoods, the only “willing” buyers are likely to be the fraudsters because they don’t care about the quality of the neighborhood or the asking price, and they can “flip” the property back to the level of the previous (inflated) value to make a tidy “buy low, sell high” profit. Since the foreclosed values are not considered, and the only sales that appear to be at fair market value are the second (or third or fourth) wave of fraud, tax assessments rise or are sustained at artificially high levels. (Figure 3)

In the immediate aftermath of the first wave of fraud, the sales prices of all properties within a quarter-mile rise by as much as 4 percent.<sup>82</sup> The fraud “bump” is welcomed by sellers and those who wish to finance their spending by tapping the equity in their homes, but the appreciation is illusory and does little except to increase the housing costs for new buyers and the tax burden for everyone else. In fraudulently inflated areas, new construction will be overpriced. When the market corrects as the fraudulent loans enter foreclosure and neighborhood values decline, newly constructed homes cannot be sold, the post-fraud purchasers will lose what equity they had, and those who tapped their equity may suddenly owe more than their homes are worth. If the borrowers used financing with negative amortization features or an adjustable interest rate, the

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<sup>82</sup> Andrew T. Carswell, “Effects of Mortgage Fraud on Property Tax Assessments”, Journal of Property Tax Assessment and Administration (2009, in press).

concentrated level of foreclosures and the drop in property values will make it impossible for them to refinance into more affordable loan terms. Nor will they be able to sell for what they owe. Trapped in loans they can no longer afford or justify economically, they default. And so begins a new wave of foreclosures and depreciation.

The cascade of negative effects from dramatically rising foreclosure rates eventually spills over into local businesses and governments. As consumer spending declines and customers are forced to move, local businesses are forced to close, which reduces tax revenues and makes it more difficult and expensive for the remaining residents to acquire basic necessities. Government expenditures swell because of the increased demand for police, fire, code enforcement, building inspection and social services in these neighborhoods. Significant resources are also diverted into the materials, manpower and legal steps that are needed for the county to maintain, secure or raze vacant properties. Property tax delinquencies rise, raising the administrative costs of collections and further reducing revenues. When the neighborhood's depreciation is finally reflected in the tax assessments and property tax revenues decline precipitously, governments whose spending was lifted by fraud during the boom suddenly find that they are heading toward a deficit. To forestall that eventuality, the governing authorities are forced to make painful cuts in budgets and services and hike property taxes, Police and fire department personnel and dispatchers may, ironically, be among the first to fall to the budget axe even as the need for their services climbs.<sup>83</sup>

### **Fighting Fraud: Why Law Enforcement Is Not The Answer**

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<sup>83</sup> "Budget Cuts Trigger Fire Alarm," *Atlanta Journal and Constitution*, December 4, 2008; CNN, "Firefighters on the Chopping Block," July 6, 2007. <http://www.cnn.com/video/#/video/politics/2009/07/06/meserve.budget.firefighters.cnn> (accessed July 6, 2009)."

For-profit mortgage fraud cases are extremely complex, involving dozens –or hundreds-- of transactions, dozens of individuals, and mountains of documents. Since the bank may be in one state, the property in another, and participants who are scattered from coast to coast, mortgage fraud cases require the coordinated effort of working groups and task forces from a variety of state and federal regulatory and criminal agencies. These investigations take, on average, a minimum of two years from initiation to indictment. In many cases, the subjects continue operating their schemes until the day they are indicted. Some have committed additional frauds after their arrest in order to generate the funds needed to pay their legal defense bills. A few have continued to operate their rings from the comfort of their prison cells.<sup>84</sup>

In the cases that are filed, and for the sake of efficiency in securing the conviction of the orchestrators, prosecutors frequently negotiate reduced sentences for minor players who facilitated the crime but who did not collect much in the way of illicit profits in exchange for testimony against those who did. Other minor players, who are not the subjects of any investigation but have learned how easy it is to commit mortgage fraud, observe the relatively favorable treatment of their peers, decide that the risk is worth the reward, and develop their own very profitable rings. In this respect, fighting mortgage fraud is a Sisyphean task akin to fighting the mythical Hydra: several new rings may spring up for every ring whose “head” is lopped off.

The economic collapse, and federal statutes of limitation, further impede prosecutors’ ability to bring perpetrators to justice. If the victim bank is a federally supervised financial institution, prosecutors have 10 years from the date of the offense to

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<sup>84</sup> See, e.g., U.S. v. McLean, 1:03-CR-00222 (N.D. Ga. 2003) and U.S. v. Milton, 1:05-CR-493 (N.D. Ga. 2005).

file charges.<sup>85</sup> But if the lender was a private mortgage bank charges must be filed within five years.<sup>86</sup> Since the fraud may not be reported for several years after origination, and criminal investigations can take another two or more years to complete, the vast majority of cases from the boom are now beyond reach.

Even when the statutes of limitation are not an issue, a further complication arises from the bankruptcy, closure and acquisition of so many lenders.<sup>87</sup> Without access to loan documents or the witnesses needed to authenticate them and testify about corporate lending practices, prosecutors are severely limited in their ability to successfully try them.

Local and state police agencies are positioned to play a critical role in the effort to prosecute fraud cases because they are much better equipped to handle the “one-off” cases that could be quickly brought to trial and serve as a warning to others. However, most jurisdictions are hampered by a lack of trained personnel, resources, and the absence of statutes that specifically criminalize the conduct.<sup>88</sup> In a time of rising crime against property and persons in neighborhoods devastated by fraud, departments with reduced financial support find it difficult to justify the diversion of critical resources away from life-and-death matters. A further disincentive to the local police and prosecutors is that the general public does not understand how fraud affects them personally and so do not demand redress. Also, in today’s climate there is little sympathy for lenders, and prosecutors fear that, given the industry’s originations practices during the boom, there is a significant chance that the jury will vote to acquit. More insidious is

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<sup>85</sup> 18 U.S.C. § 3293.

<sup>86</sup> 18 U.S.C. § 3282. In 2009 Congress expanded the definition of “financial institution” to cover private banks and mortgage brokers, who will now fall under the 10 year statute of limitations. However, the law is not retroactive and applies only to loans originated after May 20, 2009. Fraud Enforcement and Recovery Act of 2009, Public law 111-21.

<sup>87</sup> For a list of lenders that have ceased operations since 2006, see <http://ml-implode.com/index.html#lists>.

<sup>88</sup> While all states have theft and larceny statutes that allow the authorities to pursue mortgage fraud cases, the procedural, jurisdictional and proof issues that must be worked through are akin to performing neurosurgery with a sledge hammer instead of a laser scalpel.

the possibility that some prosecutors are reluctant to pursue fraud cases because the “investors” and straw buyers are constituents, political contributors, or friends and relatives.

The harsh reality is that we will never have enough time, people or money to stop mortgage fraud by attacking it after the fact. There are not enough prosecutors to handle the frauds that we already know about, much less to identify, investigate and prosecute the thousands of new frauds being perpetrated every day. While vigorous prosecution at the state and federal levels is a critical component in the overall solution, the fact remains that *prevention* is the only cost-effective way to stem the tide. Although advanced automated fraud detection technology has been available to mortgage lenders since at least 1995, it was not utilized by the vast majority of lenders during the boom. Reasons offered by lenders include that it was “too expensive” or that they identified “too much” fraud and depressed origination volume. One has to wonder what the real reasons were, given the high likelihood that fraudulent loans would eventually default and be foreclosed, at an average loss of \$30,000, compared to the cost of \$15 or less per loan to run these tools during pre-funding. As long as lenders believe that some fraud is inevitable, that the incidence is insignificant, that it’s “just the cost of doing business,” and that the costs outweigh the benefits, lenders are unlikely to prioritize fraud prevention.

## CONCLUSION

Seven million jobs have been lost since the Great Recession, sparked by mortgage fraud, began in 2007.<sup>89</sup> Nearly two million homes have been repossessed by banks since 2006<sup>90</sup> and nearly three million newly initiated foreclosures were reported through the third quarter of 2009.<sup>91</sup> \$6.1 trillion in homeowner equity has been lost since 2006<sup>92</sup> due in large part to the deflationary impact of the enormous number of foreclosures. And the storm clouds continue to gather: By the end of the third quarter of 2009 nearly 10 percent of all outstanding residential mortgages were at least 30 days past due,<sup>93</sup> the highest level ever recorded. Nearly \$19 billion worth of adjustable rate mortgages will reset by the end of 2011<sup>94</sup> Since most of these ARMs have negative amortization features and mortgage interest rates are rising, although still at historic lows, monthly payments will likely rise when they reset, sparking even more defaults, foreclosures and fraud as desperate homeowners try to escape their debts.

In order to stabilize the economy and keep an already horrendous situation from becoming a death spiral we must stem the tide of foreclosures. To do that, we must stem the tide of mortgage fraud. We need to change the residential lending focus from detecting fraud in defaulted loans to preventing fraud. In order to do that, we must mandate that all loans be thoroughly screened for fraud before they are funded, remove

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<sup>89</sup> Jonathan Weisman, "Report Raises Pressure on Obama to Focus on Jobs," *Wall Street Journal*, January 9, 2010. [http://online.wsj.com/article/SB126298709380022037.html?mod=WSJ\\_hps\\_LEFTWhatsNews](http://online.wsj.com/article/SB126298709380022037.html?mod=WSJ_hps_LEFTWhatsNews) (accessed January 9, 2010).

<sup>90</sup> Prashant Gopal, BusinessWeek.com, "Foreclosures Drop in May," June 11, 2009. [http://www.businessweek.com/lifestyle/content/jun2009/bw20090610\\_006548.htm](http://www.businessweek.com/lifestyle/content/jun2009/bw20090610_006548.htm) (accessed June 17, 2009).

<sup>91</sup> OCC and OTS Mortgage Metrics Report, Third Quarter 2009 at 40. <http://files.ots.treas.gov/482114.pdf> (accessed January 9, 2010).

<sup>92</sup> Press release, Zillow.com, Feb. 3, 2009. <http://zillow.mediaroom.com/index.php?s=159&item=103> (accessed June 17, 2009).

<sup>93</sup> Mortgage Bankers Association, "National Delinquency Survey, Q3 2009," <http://www.mortgagemag.com/news/2009/1116/1000014073070.htm> (accessed January 9, 2010).

<sup>94</sup> Prashant Gopal, "Good News: Option ARM Resets Delayed," BusinessWeek, April 16, 2009. [http://www.businessweek.com/lifestyle/content/apr2009/bw20090416\\_103126.htm?chan=autos\\_real+estate++lifestyle+subindex+page\\_real+estate+news](http://www.businessweek.com/lifestyle/content/apr2009/bw20090416_103126.htm?chan=autos_real+estate++lifestyle+subindex+page_real+estate+news) (accessed June 17, 2009).

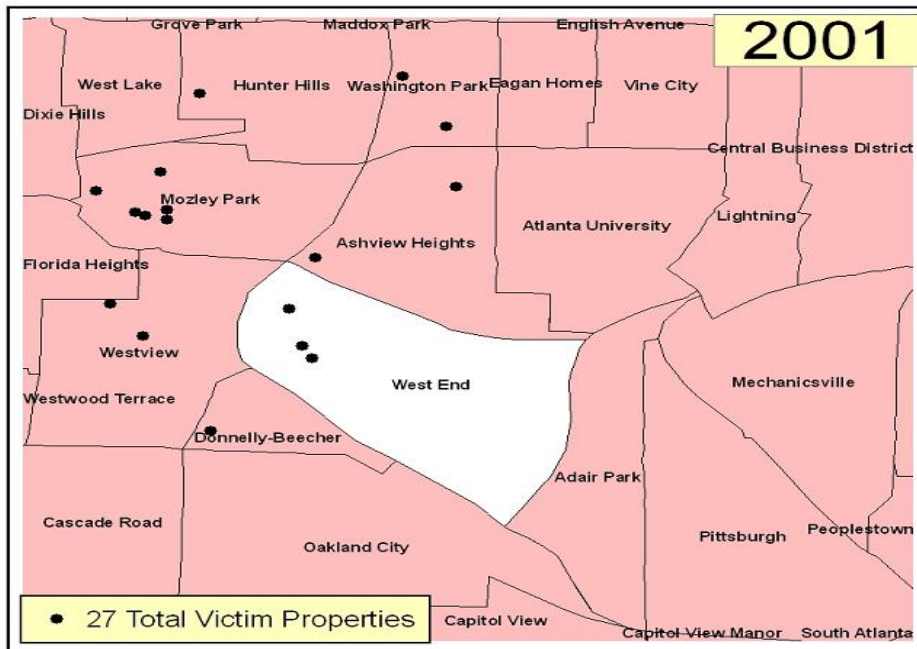
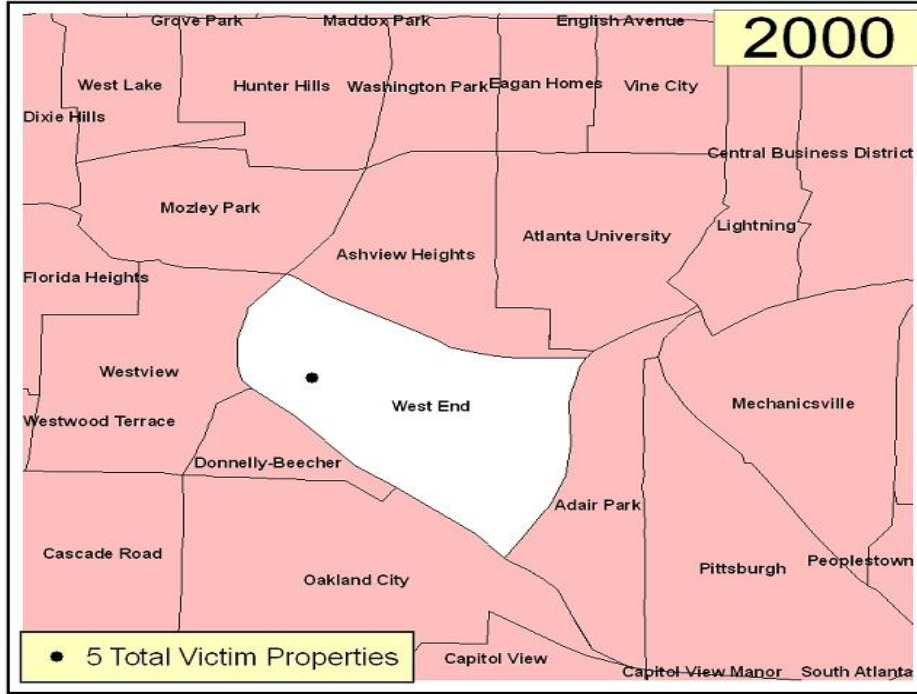
the legal barriers that impede the industry's ability to fight fraud and craft protections for those who engage in the battle. We must train our underwriters to be critical in their analysis, give them sufficient time for careful consideration and reasoned judgments, and reward them for producing quality, sustainable loans. We must craft clear and specific laws that define and criminalize fraudulent conduct to provide a precisely focused weapon for law enforcement, and provide them with the support and training they need to wield it effectively. We must educate industry professionals and the general public as to where the line is drawn between acceptable and illegal practices, and to warn them of the consequences for crossing it.

Fraud prevention has taken on a new urgency. As a result of its extensive intervention in the financial markets the federal government now purchases, insures or guarantees nearly 100 percent of loans originated today. The risk for fraud losses has thus been effectively shifted from the financial services sector to the taxpayer. If fraud is not contained it may well bankrupt the country. If we prioritize fraud prevention, we may yet save the country for our grandchildren, if not for ourselves.

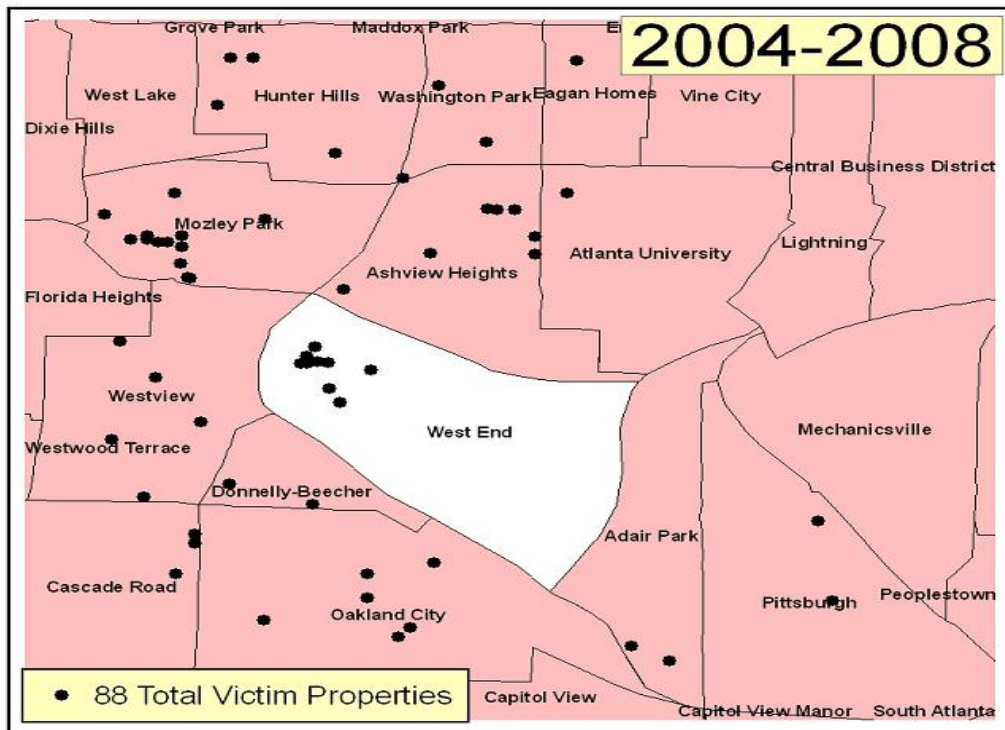
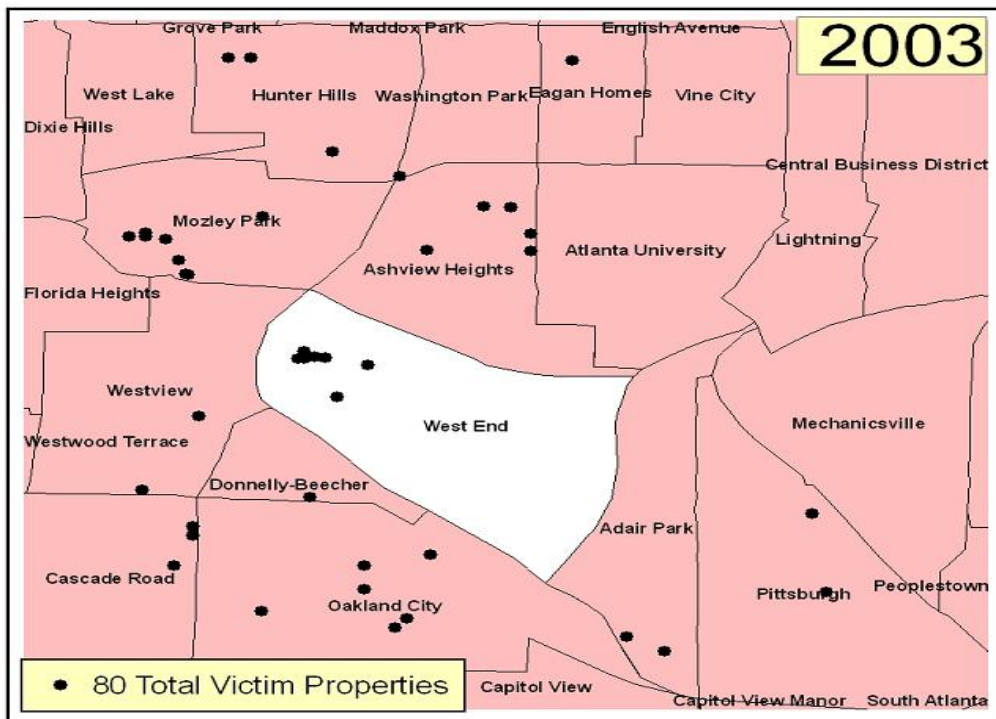


**Figure 1 Kevin Wiggins properties, Atlanta, Georgia 30310**

This figure illustrates fraud's geographic concentration and spread over time. The occurrence in this area is worse than represented because there were literally dozens of rings operating in these neighborhoods, and only Wiggins' transactions are shown.

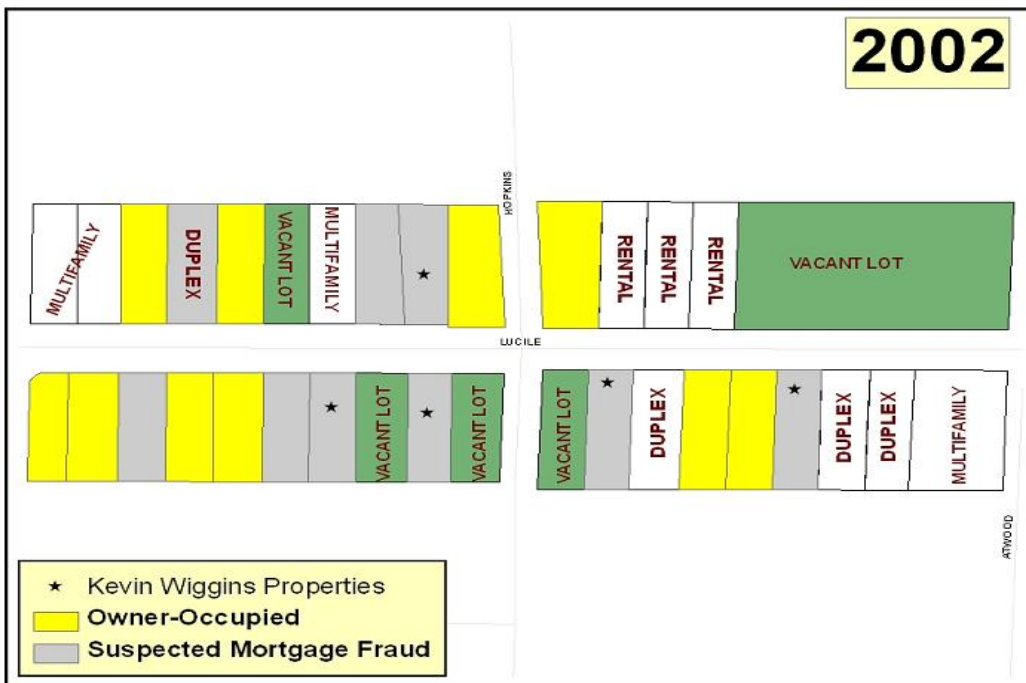
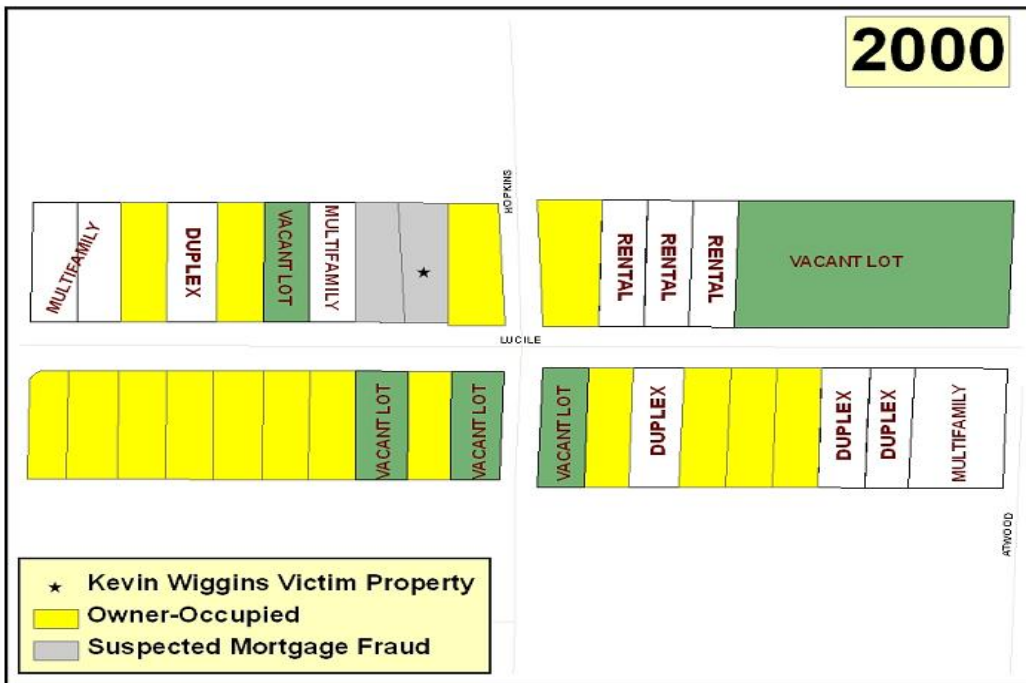


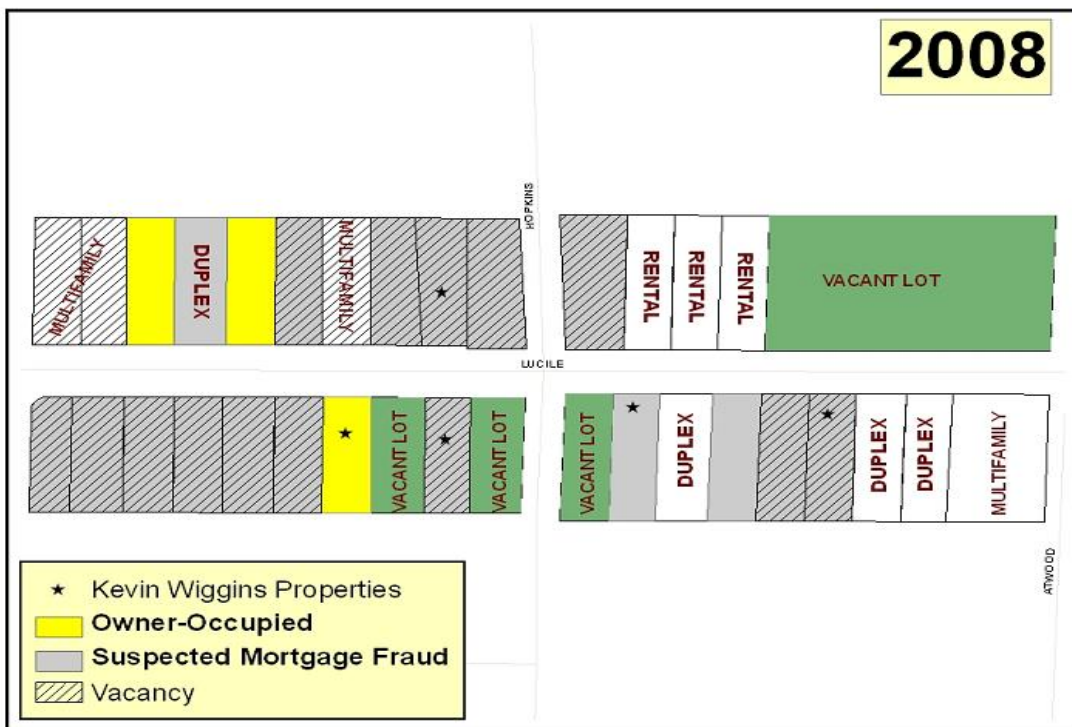
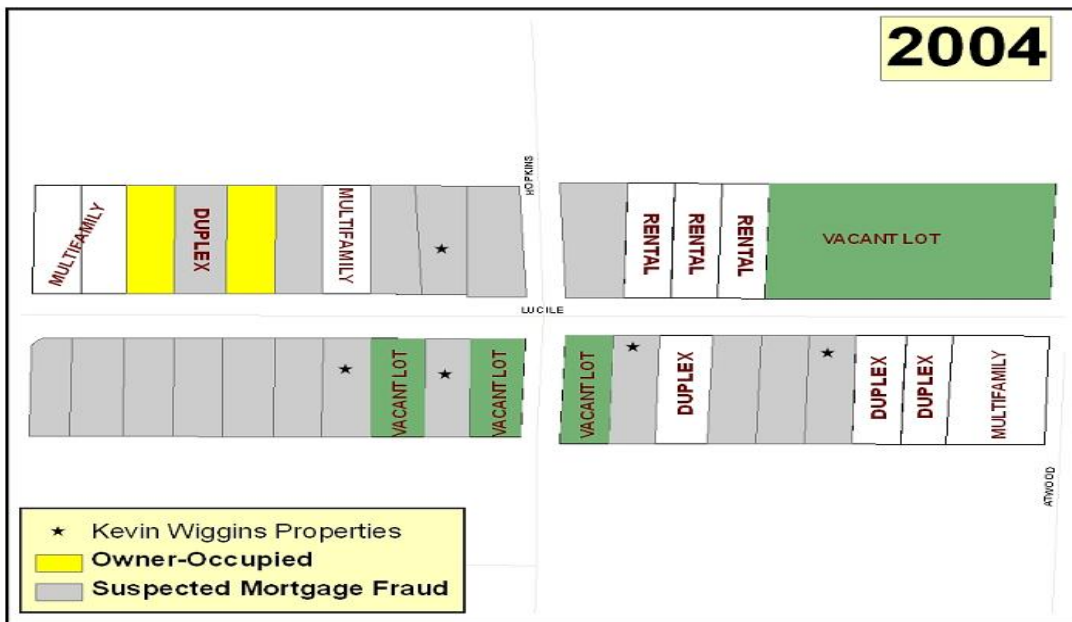
Used with permission of Brent Brewer.



Used with permission of Brent Brewer.

Figure 2 Lucile Avenue, Atlanta, Georgia 30310





Used with permission of Brent Brewer

**Figure 3 1318 Lucile Avenue, Atlanta, Georgia 30310**

This figure represents a typical sales history for a fraudulently acquired property and the effect of fraudulent sales values on tax assessment values. Under Georgia law, the property is assessed as of January 1<sup>st</sup> of each year and thus assessment changes will not appear in the digest until the next calendar year.

<u>Date</u>	<u>Purchaser</u>	<u>Sales/Foreclosure/Tax values</u>
10/03/00	FW to JK	\$ 99,000
10/03/00	JK to LL	\$155,000 Classic same day flip
	Tax value (100%)	\$ 53,400
01/26/01	LL to MJ	\$305,000 Delayed flip
	Tax value (100%)	\$ 98,800
<b>12/04/01</b>	<b>FORECLOSED</b>	<b>\$289,358</b> Early payment default
05/07/02	WaMu to BBP	\$ 72,000 Backwards flip
05/02/02	BBP to VM	\$ 95,000 (“sold” 5 days before purchase)
	VM’s mortgage	\$201,000
	Tax value (100%)	\$137,300
<b>07/01/03</b>	<b>FORECLOSED</b>	<b>\$221,000</b>
	Tax value (100%)	\$150,000
01/28/05	Bank to KA	\$150,000
03/21/05	KA to DS	\$320,000 Delayed flip
	Tax value (100%)	\$168,200
10/12/06	DS to IB	\$220,000 Transfer to avoid foreclosure
	Tax value (100%)	\$234,000
<b>01/06/07</b>	<b>FORECLOSED</b>	<b>\$202,500</b>
	Tax value (100%)	\$243,800
<b>03/17/09</b>	<b>Last sale (by lender)</b>	<b>\$ 21,000</b>
	Tax value (100%)	\$166,500
Last legitimate sale value (2000):		\$ 99,000
Current value per last sale (2009):		\$ 21,000
Depreciation over 9 years:		80%
Average value by sale price:		\$199,286
Total amount of defaulted debt		
as reflected in foreclosure values:		\$712,858
Over-valuation in tax assessment based on last sale:		790%
Over-valuation based on last legitimate sale price (2000):		60%