Mortgage Fraud: Current Trends and Issues

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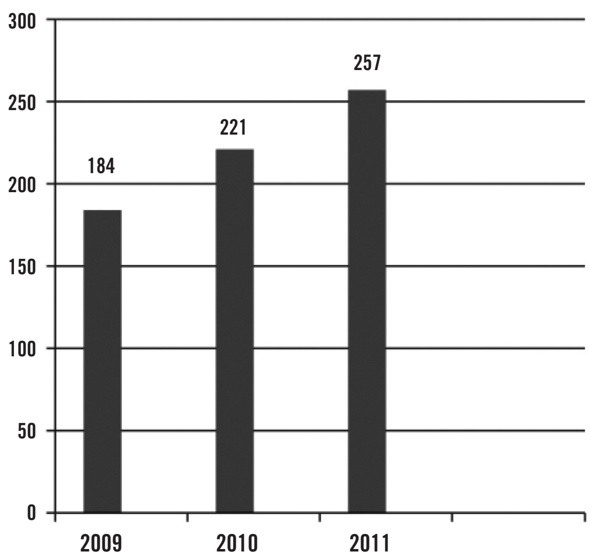
INTRODUCTION

THE STATISTICS ON MORTGAGE FRAUD CONTINUE TO BE GRIM according to various official sources. Although mortgage fraud articles have appeared frequently in the popular press, many readers may not realize the extent of the fraud that is only beginning to be officially tracked by the United States government.

With distressed economic conditions and declining housing values, the environment continues to be attractive to mortgage fraud perpetrators. According to the Internal Revenue Service (IRS), the number of mortgage and real estate fraud convictions increased by almost 40 percent from 2009 to 2011.[1] Figure 1 depicts this trend, using the most current statistical data from the IRS. In 2009 there were 184 fraud convictions, 221 convictions in 2010, and 257 in 2011. Similarly, the average prison term handed out by federal judges to defendants in these schemes increased from 35 months in 2009 to 42 months in 2011.

Figure 1

Mortgage and Real Estate Fraud Convictions Per Year



Source: Internal Revenue Service

The Federal Bureau of Investigation (FBI) defines mortgage fraud as "…a material misstatement, misrepresentation, or omission relied on by an underwriter or lender to fund, purchase, or insure a loan."[2] At the end of 2010, the FBI had 3,129 pending mortgage fraud investigations—a 12 percent increase from 2009, and a 90 percent increase from 2008. According to the FBI, 71 percent of all pending FBI mortgage fraud investigations involved dollar losses of more than $1 million. Moreover, the FBI estimates the current annual losses due to mortgage fraud are between $4 billion and $6 billion.[3] In response to the mortgage fraud threat, the FBI increased the number of agents investigating mortgage fraud cases from 120 special agents in 2007 to 325 special agents in 2011,[4] an increase of approximately 171 percent.

With high levels of unemployment, the real estate market still in a slump in many states, increasing delinquencies on mortgage loans, escalating foreclosures, and borrowers "underwater" on their mortgages, mortgage fraud schemes have become more prevalent and visible. The elevated level of mortgage fraud continues to affect conscientious homeowners, taxpayers, lending institutions and the national economy. New schemes are also emerging that threaten consumers, the safety and soundness of the financial institutions, and the national economy.

Our purpose in this article is to provide a background for real estate professionals specializing in non-commercial properties, who should be keenly aware of these schemes so that their clients are not the latest victims in this criminal epidemic. The article is organized as follows:

(1) a presentation of the manner in which the FBI collects information on mortgage fraud;

(2) a discussion of the typical perpetrators of mortgage fraud;

(3) an analysis of current mortgage fraud schemes, including examples of various types of schemes; and

(4) suggestions for preventative measures so that real estate professionals can protect themselves and their clients against being victimized by mortgage fraud.

FBI DATA SOURCES ON MORTGAGE FRAUD

The FBI gathers data on mortgage fraud in three ways, the first of which is a suspicious activity report.[5] Suspicious activity reports (SARs) are filed by federally insured financial institutions. If a national bank detects or suspects a violation of federal law, then it must file an SAR with the U.S. Department of Treasury.[6] In one instance, an SAR filed by a financial institution provided information leading to an indictment and, ultimately, a conviction of approximately a dozen individuals and a mortgage origination company for perpetrating more than $100 million in mortgage fraud over a four-year period.[7] The network of co-conspirators and accomplices would locate distressed residential real estate and, through fictitious sales of the properties, would cause the banks to front millions of dollars to finance the purchase of the properties. In one transaction, the perpetrators created an appraisal report for a duplex with a stated value of almost $500,000 when the property was nothing more than a vacant lot. A false appraisal, along with an altered certificate of occupancy for a two-family structure, was used to close the loan with the bank, resulting in fraudulently obtained proceeds of almost $500,000.

According to the Financial Crimes Enforcement Network (FinCEN), a bureau under the Department of Treasury, financial institutions submitted 92,028 mortgage loan fraud SARs in 2011, a 31 percent increase from the 70,472 submitted in 2010.[8] In the first quarter of 2012, 17,651

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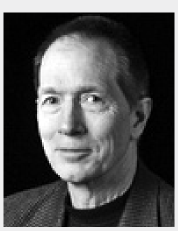

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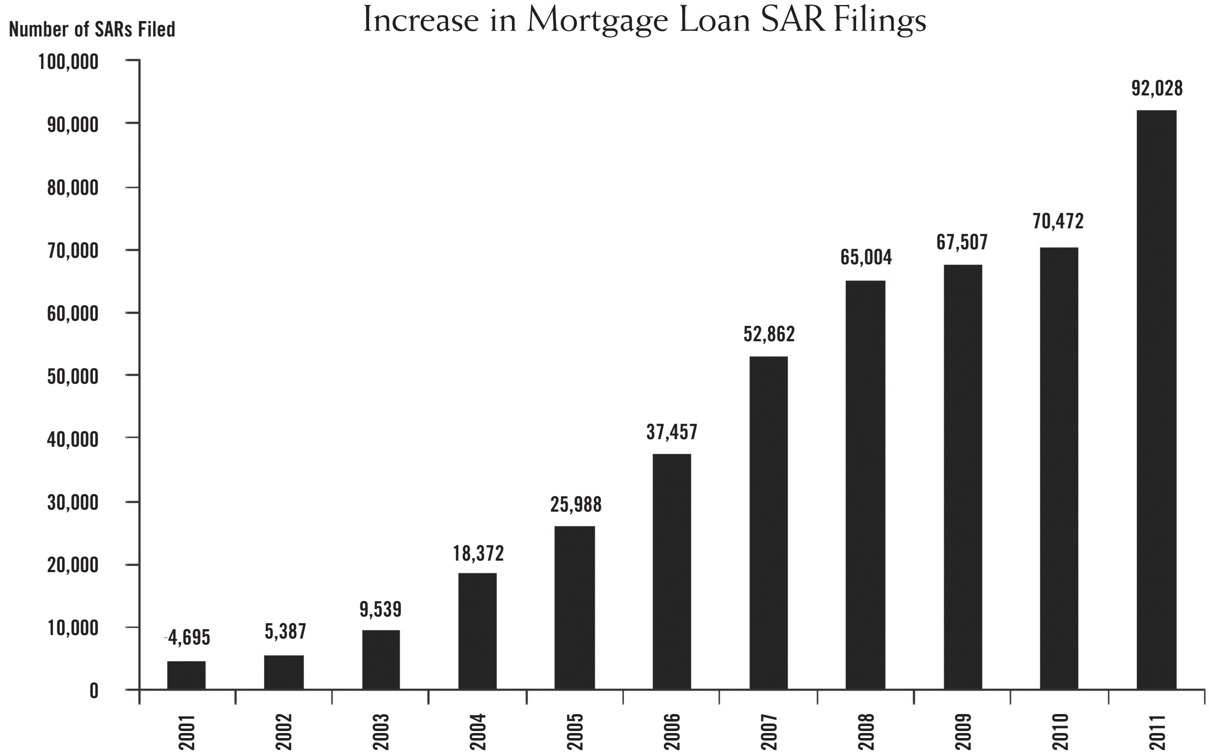
Figure 2

Increase in Mortgage Loan SAR Filings



Source: Financial Crimes Enforcement Network

mortgage loan fraud SARs have been submitted.[9] Figure 2 illustrates this increase in mortgage loan SAR filings.[10]

INCREASE IN MORTGAGE LOAN SAR FILINGS

In March 2010, the U.S. Department of Justice, in conjunction with the FBI, announced a new mortgage fraud takedown referred to as "Operation Stolen Dreams."[11] This operation lasted from March 1, 2010 through June 15, 2010. Operation Stolen Dreams targeted mortgage fraudsters throughout the U.S. and was the largest collective enforcement ever brought to bear in combating mortgage fraud. During this brief time period, the program involved action against 1,517 criminal defendants and included 525 arrests, 336 convictions and 191 civil enforcement actions. [12]

For example, Operation Stolen Dreams resulted in the arrest of two people in Miami, who targeted the Haitian-American community by claiming they would assist them with immigration and housing issues.[13] Instead, they used the victims' personal information to produce false documents to obtain mortgage loans.[14] The FBI claims that the defendants were responsible for more than $2.3 billion in losses.[15]

The second way the FBI compiles data on mortgage fraud is through reports received from the Department of Housing and Urban Development, Office of the Inspector General.[16] Lastly, the FBI receives complaints filed by the public and mortgage industry at large.[17]

TYPICAL PERPETRATORS OF MORTGAGE FRAUD

According to the FBI, mortgage fraud is perpetrated in two distinct ways: (1) fraud in order to obtain housing; and (2) fraud strictly for profit.[18] The first type of mortgage fraud occurs when there are illegal actions by a borrower, such as misrepresenting income or employment history to qualify for a mortgage loan. The second type of mortgage fraud (i.e., fraud for profit), occurs when industry insiders use their knowledge or authority to commit or aid in the fraud in order to obtain ill-gotten gains.

Also, according to the FBI, a high percentage of mortgage fraud involves collusion by industry insiders, such as bank officers, appraisers, mortgage brokers, attorneys, accountants, notaries and other professionals in the industry.[19] Mortgage professionals commit mortgage fraud when the professional:

- falsely inflates the value of the property;
- knowingly misstates false income for borrowers;
- inflates the appraisal values; or
- makes loans supported by fictitious property.

Throughout this article we describe various fraud schemes that have actually occurred and are described in various government documents and press releases. We have chosen not to identify the individuals involved, but shall simply call them "Fraudster-A," "Fraudster-B," "Fraudster-X," "Fraudster-Y" and so on.

As an example of both types of mortgage fraud in one case, a former Arizona real estate agent, Fraudster-A, was sentenced to 51 months in prison for conspiracy to commit wire fraud as part of a mortgage fraud scheme.[20] This individual acknowledged in court documents that as a principal of a real estate firm that has since collapsed, he coordinated illegal "cash back" mortgage sales on homes. In a two-year period, Fraudster-A and others purchased properties at or below market value and then sold the homes based on inflated appraisals. Some of the profits were used to provide kickbacks to the buyers with, of course, no disclosure to the mortgage lenders. These schemers would then pocket the difference. Many of these buyers made false statements on the income, employment and assets sections of the loan applications, because they would have otherwise been unqualified for the mortgage loans. A total of 49 properties were involved in the scheme, resulting in nearly a $10 million loss to mortgage lenders. Fraudster-A admitted that he and his fellow conspirators pocketed almost $2.5 million in the deals.

CURRENT MORTGAGE FRAUD SCHEMES

In addition to the "cash back" scheme discussed above, other current mortgage fraud schemes include, but are not limited to:

- short sale;
- foreclosure rescue;
- builder bailout;
- straw buyers; and
- loan origination schemes.

Short Sale Schemes

Vulnerable to short sale schemes are homeowners who are "underwater" or are in a negative equity position. In March 2011, CoreLogic, a financial data service firm, released data showing that Nevada has the highest percentage of homeowners with negative equity at 65 percent, followed by Arizona at 51 percent, Florida at 47 percent and California at 32 percent.[21] At 118 percent, Nevada had the highest average loan-to-value ratios for properties with a mortgage, followed by Arizona at 95 percent, Florida at 91 percent, Michigan at 84 percent and Georgia at 81 percent.[22]

Simply stated, a short sale occurs when the borrower cannot make the mortgage payments on the home, so the lender agrees to a sale of the property for less than the outstanding mortgage balance. The lender may forgive the deficiency balance, depending on the settlement and the state where the property is located. Sometimes the borrower is truly having financial difficulty and the short sale is not fraudulent.

However, in a short sale fraud scheme, the scammer uses a third party, known as a straw buyer, to purchase and finance the residence from the lender. In these cases the scammer will present the lender with false appraisal documents that show the residence is worth less than its true market value. Ultimately, the straw buyer defaults on the loan obtained to purchase the residence and the scammer swoops in and purchases the residence at a deep discount. The residence is then sold for its higher and true fair market value. The foregoing example is often termed "short sale flopping," and in many cases occurs when real estate agents hide—from the lender selling the property—their relationships with the buyer. Often the agents will not disclose better offers from legitimate buyers.

An example of an actual case of "short sale flopping" is exemplified by two real estate agents in Connecticut, Fraudster-B and Fraudster-C, who both pled guilty in 2010 to fraud stemming from their involvement in such schemes.[23] In one instance Fraudster-B was the listing agent on a property being sold by Regions Bank in a short sale. One outside buyer presented Fraudster-B with an offer of $132,500. However, Fraudster-B, working with Fraudster-C, falsely represented to Regions Bank that the highest offer to purchase the property was only $102,375. This bid came from an entity controlled by Fraudster-C. The bank subsequently sold the property to the controlled entity at the lower price. Fraudsters B and C then resold the property for $132,500 to the outside bidder and pocketed the difference as ill-gained profit.

Foreclosure Rescue Schemes

Homeowners who are "underwater" are also susceptible to foreclosure rescue schemes. As evidenced by Figure 3 below, which uses data from the Federal Trade Commission (FTC), foreclosure rates of residential property have been significantly increasing over the past six years.[24] With the skyrocketing number of foreclosures taking place, foreclosure rescue schemes are also proliferating.

In a foreclosure rescue scam, con artists approach homeowners who have fallen behind on their mortgage payments and convince the homeowner to transfer their ownership interest in the property. The scammers tell the homeowner to sign over the deed to the scammer to keep their home out of foreclosure. The scammer convinces the homeowner that by making "lease" payments to the scammer, the homeowner will be able to buy back the home after a certain amount of time has passed.

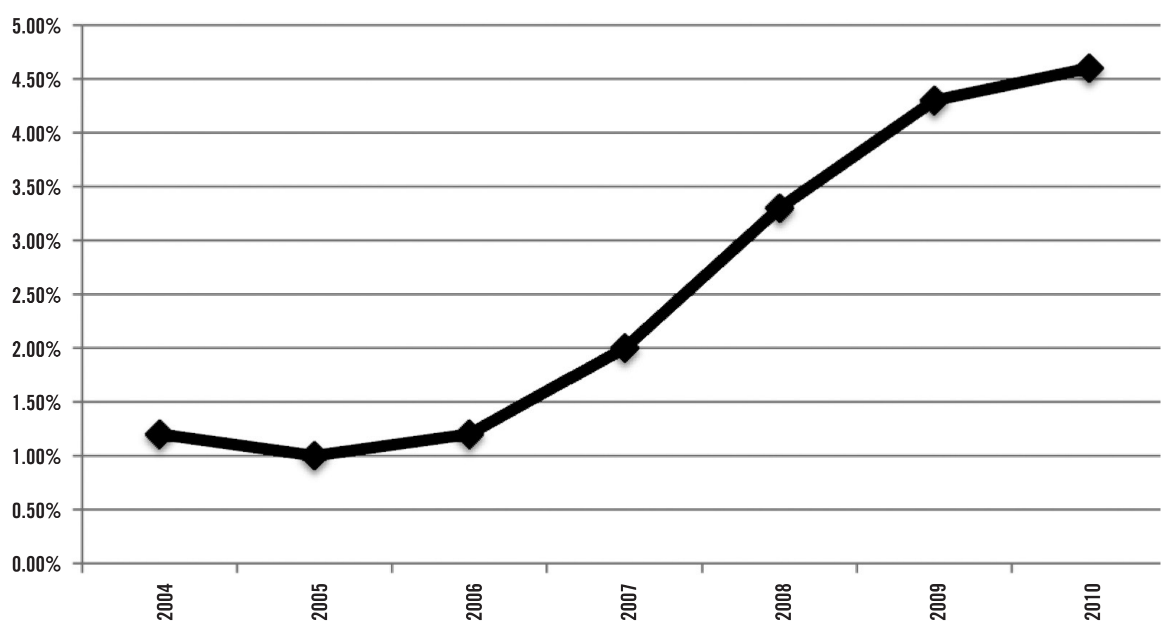
In the interim the scammer is falsely claiming to be making the mortgage payments to the lender. The reality is that once the homeowner transfers ownership (via deed) of the residence, the con artist is under no obligation to sell the property back to the homeowner and could even begin eviction proceedings against the homeowner.

Another variation of this scheme involves a con artist who contacts the defaulting homeowner, and then offers to find a lender who will refinance the delinquent mortgage through a "foreclosure rescue" loan. The scammer presents the homeowner with "loan documentation" to sign as part of the loan. Counting on the homeowner's not reading the fraudulent documentation, the scammer has the homeowner unwittingly execute a deed transferring ownership of the residence. Once this fraudulent paperwork has been executed the homeowner innocently believes that the mortgage delinquency has been resolved. Imagine the homeowner's shock when months (or even years) later, believing the rescue loan was in place, the notice arrives that the homeowner no longer owns the property, all the while remaining liable on the original mortgage.

As one actual example of this scheme, the FTC reached a settlement in December 2011 with six California defendants.[25] The settlement required them to pay back ill-gotten gains and permanently banned them from selling any mortgage assistance or debt relief products. According to the FTC, the six defendants touted a program that would supposedly reduce mortgage payments for "underwater" homeowners as part of the federal government's stimulus program, even though the defendants had no affiliation with the federal government.

Figure 3

Foreclosure Rates



Source: Federal Trade Commission

The defendants charged up to $4,250 per client and promised to reduce the mortgage payments, interest rates and even principal loan amounts. The FTC alleged that once homeowners paid the fee, they received no help in reducing their mortgage, and the defendants did not respond to emails or phone calls. Rather, the defendants had disconnected their phones and changed the names of their businesses while continuing to make promises and take money from new homeowners.

Straw Buyer Schemes

The use of straw buyers to hide the identity of the true beneficiary of the loan proceeds is another frequent type of fraud. A straw buyer, who actually takes temporary formal title to the property, is used by a fraudster who wishes to hide his identity, and his underlying fraudulent scheme, from the lender. The straw buyer only acquires ownership of the property for a brief period of time, until the fraudster is able to complete his scheme.

The fraudster recruits a person with good credit (a straw buyer) to acquire the loan and obtain formal title to the property. The straw buyer is generally paid a fee for lending their good credit to this scheme. In addition to recruiting a straw buyer the fraudster will also provide false loan documents to the lender on behalf of the straw buyer, which show an appraised value of the property in excess of its true market value. The straw buyer may participate in the preparation of the fraudulent documents but this is not always the case. The lender will then make a loan to the straw buyer based on this inflated property value. In return for his fee, the straw buyer will now transfer the loan proceeds and formal ownership of the property to the real buyer (the fraudster). As part of this scheme, the real buyer (the fraudster) pockets the loan proceeds and never makes any payments on the mortgage, sending it into default and foreclosure in no time. The lender is then "stuck" with the property, whose market value is typically well below the mortgage balance. This type of scheme is especially effective if the mortgage is a non-recourse loan in which the lender has no recourse to anyone's other assets.

One individual, Fraudster-D, a former Missouri real estate agent, was sentenced to 20 months in prison and ordered to pay restitution in the amount of $5,634,747 for her role in a straw buyer mortgage fraud conspiracy.[26] According to court documents, Fraudster-D devised the mortgage fraud scheme along with two mortgage loan officers and 15 straw buyers to purchase homes at inflated prices. Loans were extended to buyers for more than the actual sale price, based on false information provided to the mortgage lenders, enabling the buyers to keep the extra loan proceeds without the lenders' knowledge. To conceal the kickbacks, the conspirators created shell companies that submitted false invoices to title companies. For the sale of each house, the buyers received kickbacks of about $100,000. In the total course of the scheme, lenders approved loans for 25 homes totaling more than $12.6 million. From this amount, buyers received more than $2.3 million without the lenders' knowledge and Fraudster-D received "commissions" and other payments totaling $405,197.

Straw buyer activities often are used when a family member purchases a home for the true homeowner (another family member) who would not otherwise qualify for a mortgage loan. For example, assume a recent university graduate wants to purchase her first home. Because of her student loans, an entry level work position and very little cash for a down payment, she does not qualify for the mortgage loan. To help this new graduate, her father obtains the loan, believing that she will make the monthly mortgage payments. She moves into the house, but after several months cannot make the mortgage payments. The lender contacts the straw buyer (the father) to discover that the straw buyer does not live in the home and has no intention of making the payments his daughter was supposed to make. At this point, the lender must foreclose on the property.

Builder Bailout Schemes

Yet another type of mortgage fraud includes builder bailout fraud. Because of the saturated market of unsold new homes and units in condominium complexes, builders are experiencing difficulties in selling their inventory. As builders feel the pressure to pay outstanding construction loans, they sometimes resort to fraudulent methods. The FBI gives an example of a builder offering excessive incentives to cash-poor buyers of the new homes and then not disclosing the incentives to the lender.[27] These incentives include no money down or paying closing costs for the buyer. In these cases the lender is hoodwinked into financing a larger percentage of the loan than they originally believed, often leading to high loan-to-value ratios, perhaps exceeding 100 percent.

For example, the builder might sell a house to a buyer for $300,000, when its true market value is $250,000. The buyer is also asked to make a $50,000 down payment to the builder. The builder has already agreed with the buyer to forgive this $50,000 down payment, which of course is obviously not known to the lender. The lender will then fund the loan at the remaining $250,000, believing that the buyer has paid the builder the $50,000 down payment so that there is already equity of $50,000 in the property. The builder takes the $250,000, which was the agreed sales price with the buyer, and then "forgives" the buyer's $50,000 down payment. The effect here is that the lender has unwittingly financed 100 percent of the $250,000 value of the home, which was never the lender's intention. Without the fraudulent scheme, the loan to the buyer would not have occurred.

The following cites an actual case of this fraudulent activity: On April 15, 2012, Fraudster-X was sentenced to 35 months in prison for his part in a builder bailout scheme. Fraudster-X, a real estate developer and also an attorney and CPA, had built up a substantial inventory of homes that were not selling in the depressed real estate market.[28] He was approached by another individual, Fraudster-Y, who, through the use of straw buyers, offered to buy the homes at $40,000 to $60,000 above the listed price. Fraudster-Y created fraudulent documents that enabled these straw buyers to qualify for 100 percent financing of the listed prices. The total financing for 62 homes was approximately $21 million. After receiving these funds, Fraudster-X then wrote checks totaling $2.5 million back to Fraudster-Y, who pocketed most of this after paying a commission to his straw buyers. These price rebates from Fraudster-X to Fraudster-Y were not disclosed to the lenders. Most of the homes resulted in foreclosure and lenders lost several million dollars. For his part in the scheme, as well as many others, Fraudster-Y also received a lengthy prison sentence.

Another example of the builder bailout fraud takes place when the builder lures a real estate investor by offering property management services for rental property, along with an agreement that the builder will absorb any negative cash flow from the property for a certain period of time. Once the investor has purchased the property, the builder reneges on his promise to manage the property, or even his obligation to finance any negative cash flow from the property. Typically in this situation the builder has also overstated the income potential of the property.[29]

Mortgage Loan Origination Schemes

Loan origination schemes involve methods such as falsifying a borrower's financial information, using stolen identities, witnessing false documents, flipping property with phantom rehabilitation, employing fictitious assets, and fabricating payroll documents. If a borrower's income, assets, liabilities and employment are falsified to qualify the borrower for a mortgage loan, this is mortgage fraud. The borrower who supplies fictitious or false bank statements, W-2 forms or tax returns is committing mortgage fraud.

In one case Fraudster-Z, the former CEO of a large mortgage origination firm, was sentenced to 63 months in prison, three years' supervised release, and ordered to pay $11,994,000 in restitution in connection with an $11 million fraudulent loan scheme.[30] According to court documents, the mortgage firm was in the business of originating residential home loans. The mortgage firm assisted borrowers in putting together mortgage applications and qualifying the borrowers for home mortgages.

Although the mortgage firm would originate the mortgage loans, after origination the firm would re-sell the loans to another financial institution in the secondary mortgage marketplace. Fraudster-Z admitted he prepared and sold fraudulent mortgage loans from 2008 through September 2009. After the mortgage firm had originated a mortgage loan and sold that loan to a third-party lender, Fraudster-Z would create a subsequent set of fraudulent loan documents for the same property. He would then sell the second set of falsified loan documents to another third-party lender, even though the actual mortgage loan for that property already had been sold. As a result of these bogus loans, Fraudster-Z received over $11 million in illicit proceeds. Fraudster-Z used these illicit proceeds to support his lavish lifestyle which included his multi-million-dollar home, exotic travel and exclusive seating at a major professional sports arena.

PREVENTATIVE MEASURES FOR PROFESSIONALS

Practitioners can protect themselves and their clients against mortgage fraud and help stop this epidemic by being aware of the warning signs. Real estate professionals should document transactions and keep those records in accordance with existing office documentation retention and destruction policies.

If a buyer is encouraged to falsify a mortgage application or sign a blank loan application, these are mortgage fraud indicators. When a borrower inflates income on a loan application in order to qualify for a loan beyond his or her financial means, this lie is illegal. To avoid being caught in this trap, the lender should always verify employment and income and document the findings thoroughly.

Another tip in protecting yourself and your clients from mortgage fraud is to get referrals for professionals such as real estate agents and lenders. Both realtors and lenders have professional associations and organizations that are available to share best practices to guard against mortgage fraud.

The National Association of REALTORS® (www.realtor.org)[31] lists many professional institutes, societies and councils. Some examples are:

- The Council of Real Estate Brokerage Managers® (CRB) (www.crb.com)[32] offers "educational, informational and networking resources … " to certified real estate brokers;
- The Counselors of Real Estate® (CRE) (www.cre.org),[33] a professional organization that serves as an information resource to real estate professionals and facilitates networking and the sharing of common concerns;
- The Women's Council of REALTORS® (WCR) (www.wcr.org),[34] which connects more than 18,000 real estate professionals; and
- The American Bankers Association® (ABA) (www.aba.com)[35] also offers many resources, including ABA Professional Networking Sites (www.aba.com/Members/Pages/ProfSites.aspx),[36] designed to provide current mortgage fraud information and exchange information of current interest to ABA members.

The exclusive use of only one real estate appraiser should also raise suspicions. Appraisal fraud is categorized as a fraud for profit scheme by the FBI.[37] In this scheme, the real estate appraiser is in collusion with the borrower. Often, the real estate appraiser will inflate the property value for the borrower who will then pay off the appraiser at the closing of the loan. The dishonest appraiser can also act in collusion with a mortgage broker by providing an inflated value of the real property.

Fraud also occurs when sellers lie about the value of the improvements made to the property, loan documentation is altered, or kickbacks are paid to the buyers, brokers, appraisers or title companies. A fraudulent down payment made through fictitious, falsified, forged or altered documents supplied to the lender to meet the loan-to-value requirements is a fraudulent scheme. Suspicious deeds, such as the use of several quit-claim deeds conveying property to inactive corporations or limited liability companies, should be scrutinized to determine if mortgage fraud might be taking place. A check of both the county public records, as well as the website of the state's division of corporations for the status of business entities is one method of fighting mortgage fraud. The buyer/borrower who provides his or her own real estate comparables, offers a bribe to the real estate appraiser, or points out defects in the property to the appraiser should raise concern as to the possibility of short sale fraud occurring.

The FBI provides several additional mortgage fraud indicators, all of which should aid the real estate professional in suspecting a fraudulent scheme is in the works. Some additional "red flags" are:

- increased commissions and bonuses paid to mortgage brokers and real estate appraisers at closing or outside of closing;
- supporting loan documentation in which an individual is requested to sign blank forms; and
- using investors to flip property for a fixed percentage.[38]

CONCLUSION

There are as many mortgage fraud schemes as there are perpetrators determined to find loopholes in the lending industry and the legal system. These schemes seem to be particularly resilient and appear to adapt to revisions in lending practices. Current homeowners, future homeowners, real estate investors and other professionals should be aware of the types of mortgage fraud in order to protect themselves from being caught up in a scheme. As mortgage fraud continues to reach new heights, everyone (e.g., lending institutions, professionals, communities and consumers) can help detect and prevent fraud by understanding the many faces of fraud, being alert to the red flags and reporting suspicious activity to the appropriate governmental agency.

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35. *http://www.aba.com/Pages/default.aspx.*

36. *http://www.aba.com/Members/Pages/ProfSites.aspx.*

37. Op. cit. at 5.

38. Op. cit. at 18.