STATEMENT

OF

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"MORTGAGE FRAUD AND ITS IMPACT ON MORTGAGE LENDERS"

BEFORE THE

SUBCOMMITTEE ON FINANCIAL HOUSING AND COMMUNITY OPPORTUNITY

UNITED STATES HOUSE OF REPRESENTATIVES

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Introduction

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

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

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

Through our affiliation with Lanahan & Reilly, TPG mitigates losses associated with mortgage fraud. We have assembled one of the strongest, most experienced mortgage banking practices in the country dedicated to the eradication of mortgage fraud. The attorneys on my team are specialists in loss mitigation, fraud investigation, recovery analysis, foreclosure, demand management, and litigation. Our clients include major banks, thrift institutions, mortgage companies, secondary market investors, securities issuers, and other financial services companies.

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

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

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

Mortgage Fraud Defined

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

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

The Extent of Mortgage Fraud

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

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

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

The Victims of Mortgage Fraud

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

Take the following example:

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

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

Predatory Lending vs. Mortgage Fraud

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

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

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

Industry Acts to Identify and Prevent Fraud

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

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

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

<u>Appraiser Liability</u>

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

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

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

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

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

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

Flip Transactions and the Settlement Agent

A flip transaction in and of itself is not illegal. Quite commonly, these legal transactions involve individuals or companies that have purchased foreclosed properties at lower than current value prices, and/or have added cosmetic repairs to the property and resell those properties for relatively modest profits. However, the ”illegal flip” involves a somewhat different fact pattern. There, the perpetrator contracts to purchase a property. Many of these properties are HUD properties recently foreclosed upon and have very little value. The ”buyer” then obtains an inflated appraisal from a co-conspirator appraiser. The financial credit used for loan approval is fabricated or misrepresented. The property is then sold to either an innocent third party who is left with a house he or she cannot afford, or to a straw-buyer, simply an alter ego for the perpetrator. Patience is not the virtue of these "flippers," who often flip the property within days or even hours after the original purchase.

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

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

Conclusion

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

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

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