Testimony

Before

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

of the

COMMITTEE ON FINANCIAL SERVICES

Regarding

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

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

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

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

The over-appraisal is the key to the scheme. The flipped properties are often over-appraised by tens of thousands - and in some cases by hundreds of thousands - of dollars by

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

appraisers colluding with the one-stop shop and with the originating lenders. One-stop shops generally work with one or a few originating lenders that cooperate in the scheme. The scheme is successful because the originating lenders are willing to make loans based on the bogus appraisals, loans which they quickly turn around and sell into the secondary market.

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

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

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

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

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

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

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

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

Ms. W is a 68-year-old African American retired school aide, living on Social Security benefits, who sought to purchase her first home after being priced out of her long-term apartment. After seeing an advertisement in the newspaper for a one-stop shop, Ms. W called to make an appointment to see the homes that they were offering for sale. The one-stop shop

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

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

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

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

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

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