STATEMENT

of

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on

"Mortgage Fraud and Its Impact on Mortgage Lenders"

before the

Subcommittee on Housing and Community Opportunity

Committee on Financial Services

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

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

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

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

Consumers have been the primary beneficiaries of the real estate finance system. Our residential finance system, though intricate, has created more mortgage products than ever before, reaching more homebuyers than ever before. Mortgage bankers play a central role as risk intermediaries in this system, allowing funds to flow from the capital markets to consumers. Lenders underwrite loans, then extend credit on terms and conditions commensurate with the level of risk involved. In this capacity, mortgage bankers bear nearly all the risk of mortgage fraud.

Mortgage fraud is a growing part of our residential mortgage system that costs the industry and consumers millions of dollars each year. Today, mortgage industry leaders are extremely concerned that mortgage fraud against the lending community has grown quite large in the past several years with devastating consequences to lenders, and depending on how the fraud is perpetrated, to taxpayers, consumers and communities.

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

What is mortgage fraud?

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

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

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

Lenders are victimized by fraud

As an example, a small mortgage company with a good reputation in the southwest was defrauded by a single loan officer. The loan officer was debarred from FHA programs for one year and has since worked for other companies and is still in the industry. The company was also debarred from the FHA program at the completion of the investigation, four years after the fraud was committed and was forced to close. Owners who had built up the company lost their investment and over 30 employees lost their jobs because of the crimes of a single person.

Taxpayers suffer from fraud schemes

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

The couples obtained “straw buyers” – individuals who are paid for the use of their names and Social Security numbers to obtain a mortgage – and used proceeds from the loans, often for homes that did not exist, to benefit a mortgage company owned by one of the couples. More than $5 million in false notes were sold on the secondary market, but once discovered that the notes were false, the investor ordered the mortgage company to buy back the loans. Instead of repaying the investor, the criminals pooled the notes into mortgage securities, backed by Ginnie Mae, and sold them to investors. Once the scheme had been discovered, investigated and prosecuted, it was estimated that taxpayers were bilked out of more than $35 million.

Homebuyers are victimized by fraud

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

Neighborhoods suffer from fraud schemes

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

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

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

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

Mortgage industry response to mortgage fraud

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

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

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

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

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

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

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

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

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

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

3. **The mortgage industry needs to continue to innovate with the development of better industry tools and intra-industry communication to combat fraud.**

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

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

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

- Communication between mortgage lenders is hampered by the fear of law suits if one company discloses to another the results of its investigations into fraud. Some form of “safe harbor” is critical for the type of communication necessary for the industry to protect itself, and consumers, against fraud.

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

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

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