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Chairman Ney, Ranking Member Waters and members of the subcommittee, my name is William Matthews and I am the vice president and general manager of Mortgage Asset Research Institute, Inc. also known as MARI, based in Reston, Virginia. MARI builds and maintains cooperative databases for the residential mortgage and financial services industries that are used to screen new business partners and relationships. I am pleased to testify today about mortgage fraud and its impact on mortgage lenders.

MARI was founded in 1990 and was acquired by ChoicePoint Services, Inc. in June of 2003. ChoicePoint, headquartered in the Atlanta area, is the leading provider of identification and credential verification services for making smarter decisions in a world challenged by increased risks. Serving the needs of business, government, non-profit organizations and individuals, ChoicePoint works to create a safer and more secure society through the responsible use of information while ensuring the protection of personal privacy. ChoicePoint recently celebrated its seventh anniversary as an independent company that is publicly traded on the New York Stock Exchange.

MARI’s database, called the Mortgage Industry Data Exchange (MIDEX), was established on the premise that unethical and illegal activities in the residential mortgage industry could be significantly reduced though the responsible exchange of information among mortgage lenders, investors and insurers. MIDEX, a cooperative database, contains three basic types of information on companies and industry professionals:

1. Non-public incidents of alleged fraud, material misrepresentation and serious misconduct perpetrated by mortgage industry professionals and companies.

   These incidents are contributed by members of the cooperative database who include over 400 lenders, private mortgage insurance companies and mortgage investors.

2. Public sanctions and legal actions.

   These sanctions are collected from over 200 federal and state regulators in the mortgage, securities, commercial bank, real estate and appraisal industries.

3. State and federal licensing data for the mortgage and commercial banking industries.

   The licensing data comes from over 60 federal and state regulators.

Today, thousands of companies are searched each day through MARI’s MIDEX database by members of this cooperative system in an effort to screen prospective and existing business partners.

Types of Mortgage Fraud

A basic industry definition of mortgage fraud is when a consumer or professional intentionally causes a financial entity to fund, purchase or insure a mortgage loan when the entity otherwise would not have done so if it had possessed the correct information.

There are three basic types of fraud in the residential mortgage industry:

1. Consumer fraud, or fraud for property, is perpetrated by borrowers when they misrepresent information on the loan application in order to purchase a more expensive home than one for which they would normally not qualify.

   Consumer fraud is relatively minor and does not usually result in significant losses to a financial institution.

2. Commission fraud is defined by one or more industry professionals misrepresenting information in a loan transaction in order to receive a commission on a loan that would not normally be acceptable to a lender.

   Commission fraud is a more common practice in the industry and is a concern to financial institutions. It can result in harm to the consumer and losses to lenders and insurers.

3. Fraud for profit consists of systematic transactions by industry professionals who are attempting to steal a significant amount of the funds associated with one or more mortgage transactions.

   This type of fraud usually involves multiple parties in various disciplines within the mortgage industry, such as mortgage originators, appraisers, real estate agents, closing agents, builders and title companies.

   Fraud for profit usually results in significant—if not catastrophic—losses to financial entities involved in mortgage loan transactions and is of major concern to the mortgage industry. A few examples of this type of fraud include land flips, fictitious lien releases and diversion of funds at closing.

Sample Incident of Mortgage Fraud

Let me give you an example of an incident in MARI's MIDEX database that typifies some of the problems and challenges that the industry is facing. In 1997, the National Association of Securities Dealers (NASD) debarred and fined a South Carolina stockbroker who received a $10,000 customer check and converted the proceeds for his own use. The broker, whom I will refer to as John Smith, subsequently became a loan officer with a national lender. Smith's employer ultimately suspected that Smith was engaged in fraudulent activities and, after reviewing approximately 500 loan files originated by Smith found that close to 20 percent contained inflated appraisals resulting in losses of approximately $2.5 million. Unbeknownst to Smith's employer, Smith started his own mortgage company at the same time he was working for the national lender. In August 2002, Smith pled guilty to wire fraud and received a sentence of five years probation.

This incident illustrates the need for proper hiring procedures within the mortgage industry and a central repository to track industry professionals found guilty of fraud from industry to industry or state to state or company to company.

How Prevalent is Mortgage Fraud?

How much fraud occurs in the mortgage industry and what is the cost of this fraud each year?

The answers are easy: The amount of fraud and its cost are unknown and, perhaps, unknowable at this time. The primary reason is that there is no central organization that collects this information. The closest we come to this is the Financial Crimes Enforcement Network ("FinCEN") which collects information from Suspicious Activities Reports ("SARs"). While FinCEN gathers information on mortgage fraud, the primary purpose of its data collection activities in the past has been to track money laundering. Also, the SARs only cover activities at federally insured financial institutions. A SAR is not required by state-chartered mortgage lenders that are not affiliated with an insured financial institution.

However, based on FinCEN statistics and information provided to MARI by its clients, the number of incidents of mortgage fraud is increasing and the types of incidents are becoming more severe and costly to the industry.

Ramifications of mortgage fraud to the industry range from monetary losses incurred by financial companies to destroyed professional reputations and even criminal and administrative actions. The financial losses incurred by a company can be catastrophic.

Ramifications to the consumer are higher loan rates and fees, stolen identities and possibly impaired credit ratings.

Ramifications to a neighborhood victimized by mortgage fraud can include higher property taxes, inability to sell homes, increased criminal activity and abandoned properties. It often takes years for a neighborhood to recover from the damage caused by mortgage fraud.

Mortgage Fraud Trends

I would like to point out some trends of alleged fraud and misrepresentation that occur in the residential mortgage industry in the United States. These trends were derived from incidents contributed to MARI's MIDEX database by a wide cross section of mortgage lenders, insurers and investors.

- During the past four years, there has been a shift in the states that have the greatest problems. Georgia and Nevada have caught up to and surpassed California and Florida as the states with the highest fraud scores.

  In the past, fraud rates from California and Florida have led the nation by a substantial margin. Florida and California continue to have high fraud scores, but Florida now ranks only third and California has slipped to eighth place behind Utah, South Carolina, Colorado and Illinois.

- Early payment default (EPDs)[1] information from LoanPerformance, Inc. indicates problems in several metropolitan areas and is consistent overall with the results reported by MARI's database subscribers.

[1] LoanPerformance defines an EPD loan as one that goes 90+ days delinquents in its first year.

Loans that become delinquent more than ninety days in their first year do not necessarily involve fraud. However, many such loans involve some form of misrepresentation and should probably not have been made.

- The types of problems found in loan fraud files (such as fraud associated with the application, tax returns and financial statements, appraisal, etc.) seem to have been relatively stable over the last four years.

Specific details and back up documentation for each of these trends is provided in the Appendix.

Conclusion

I appreciate the opportunity to testify on MARI's behalf regarding the impact fraud is having on the residential mortgage industry. Mortgage fraud is a significant problem. Based on submissions to MARI's database, it is not only increasing, but the types of fraud are becoming more severe. Fraud not only causes losses to financial institutions, it also causes higher prices to consumers. I would be happy to entertain any questions by the subcommittee.

Appendix

In the past, fraud rates from California and Florida have led the nation by a substantial margin. Florida and California continue to have high fraud scores, but Florida now ranks only third and California has slipped to eighth place. Table 1 below was developed from fraud cases submitted to MARI by MIDEX subscribers, and it shows that for loans originated[2] during the past four years, these two states have lost their distinction as the nation's leading hot spots.

Table 1

MARI Fraud Index (MFI) By State 2000 through 2003		
Rank	**State**	**MFI**
1	Georgia	250
2	Nevada	243
3	Florida	237
4	Utah	221
5	South Carolina	175
6	Colorado	160
7	Illinois	146
8	California	144
9	Maryland	132
10	Missouri	121
NA	Washington, DC	364

Source: Case submissions to the MIDEX system

A MARI Fraud Index (MFI) of 0 would indicate no reported fraud from a state. An MFI of 100 indicates that the reported fraud for a state is exactly what one would expect in terms of fraud rates given its population size (that is, a state with an MFI of 100 is "average").

[2] The dates used in MARI's Fraud Index are the loan origination dates. Subscribers to the MIDEX system may not discover that a loan involved fraud for months, or even one or two years, after it was originated. Therefore, these numbers are dynamic—especially the 2003 component.

Early Payment Defaults Indicate Possible Fraud

LoanPerformance, Inc.[3] collects monthly payment data on more than 42 million loans. An analysis prepared by the LoanPerformance staff is presented in Table 2 below. It shows prime loans' EPD scores for various metropolitan statistical areas (MSAs) around the country. (An EPD score of 100 indicates an area where EPDs are average for the United States.) The years designated by columns in Table 2 refer to the origination years. The ten MSAs listed in the first column of the table are those that have EPD rates at least twice the national average for the 2003 book of business.

The first six MSAs listed in Table 2 show steady and, in most cases, dramatic increases in their EPD rates over the past four years.

Table 2

LoanPerformance, Inc. Data on Prime Loans Early Payment Defaults 2001-2004					
MSA	**2004 Rank**	**2004**	**2003**	**2002**	**2001**
Dallas-Ft. Worth	1 (tie)	300	284	239	187
Atlanta	1 (tie)	300	268	202	159
San Antonio	3	275	258	219	155
Jacksonville	4	250	137	118	106
West Palm Beach	5 (tie)	225	63	33	33
Newark	5 (tie)	225	158	116	135
Houston	7 (tie)	200	195	157	119
Miami	7 (tie)	200	137	75	58
Denver	7 (tie)	200	237	182	163
Kansas City	7 (tie)	200	116	116	119
Charlotte	7 (tie)	200	205	172	133
Salt Lake City	7 (tie)	200	295	200	208
Greensboro	7 (tie)	200	153	113	116

Source: LoanPerformance, Inc.

[3] Formerly Mortgage Information Corporation, aka MIC.

The LoanPerformance information for subprime loans is not sufficiently robust to be statistically valid for all MSAs. Therefore, it is aggregated by state. The ten states with LoanPerformance EPD scores of more than 175 are shown in Table 3 below.

Table 3

LoanPerformance, Inc. Data on Subprime Loans Early Payment Defaults 2001-2004					
State	**2004 Rank**	**2004**	**2003**	**2002**	**2001**
Vermont	1 (tie)	267	109	138	80
West Virginia	1 (tie)	267	77	104	98
Georgia	3	242	175	113	92
Indiana	4	221	165	144	117
South Carolina	5 (tie)	188	174	171	146
Utah	5 (tie)	188	164	141	101
Minnesota	7 (tie)	183	158	123	94
Alabama	7 (tie)	183	127	101	89
Oklahoma	9 (tie)	179	176	144	124
Louisiana	9 (tie)	179	147	124	106

Source: LoanPerformance, Inc.

In most of the states listed in Table 3, the 2003 subprime EPD rate has risen significantly over the past four years. Several of the states with the highest 2003 EPD rates have seen this problem almost double. Vermont, West Virginia, Georgia, Minnesota and Alabama started out with EPD rates below the national average in 2001.

While EPD scores do not necessarily indicate fraud, the conclusions that can be drawn from the LoanPerformance data are consistent overall with the results reported by MARI's database subscribers.

<u>Types of Fraud Reported</u>
MARI's MIDEX system classifies the types of alleged fraud involved in each incident reported by its cooperating subscribers. These classifications are shown in Table 4 for loans originated in the four-year period from 2000 through 2003. The data on 2003 loans is very preliminary since frauds perpetrated in 2003 will continue to surface for another two years or more.

Table 4 shows the percentage of each fraud classification, as drawn from the information on all fraud cases submitted to the MIDEX database. For instance, 63% of the incidents of fraud reported to the database for mortgages originated in 2003 contained application fraud. (This is not surprising given the comprehensive nature of the application form.)

Table 4

Mortgage Fraud Trends				
Fraud Classification	**Mortgage Origination Year**			
	2003	**2002**	**2001**	**2000**
Applications	63%	64%	66%	60%
Tax and Financial Statements	31%	27%	24%	25%
Verifications of Employment	12%	14%	16%	19%
Verifications of Deposit	14%	16%	16%	21%
Escrow/Closing	9%	18%	17%	20%
Appraisals/Valuations	15%	25%	22%	26%
Credit Reports	1%	1%	2%	2%

Source: Case submissions to the MIDEX system

There appear to be few discernable patterns or trends in the data for this four-year period. However, it is interesting to note that the total percentage for each year (the sum of each column in Table 4) exceeds 100%. This is because most reported incidents involve more than one type of fraud.

Appraisal Fraud

Even casual observation of Table 4 indicates that the amount of appraisal fraud reported is somewhat lower than one might expect in each of the years, especially in 2003. The low levels of reporting can be tied to the fact that, typically, reported incidents involve more than one type of fraud. If the reporting lender finds misrepresentation in the VOE and in occupancy status, that lender is not likely to spend the funds necessary to verify appraisal fraud, even if the appraisal appears to be invalid.

Some MIDEX subscribers indicate that attempts at appraisal fraud are much higher than Table 4 shows, but some loans are not closed due to the faulty appraisal’s comparison to the values produced by an automated valuation system.