Mortgage Fraud and Predatory Lending: WHAT EVERY AGENT SHOULD KNOW

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Second Edition
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Financial Crisis

learning objectives

After completing this chapter, you will be able to

- describe how industry insiders can perpetrate fraud,
- discuss how mortgage fraud impacts individuals and neighborhoods,
- explain several causes of foreclosure, and
- list types of fraud.

Key Terms

- appraiser
- blacklist
- Dodd-Frank Wall Street Reform and Consumer Protection Act
- flipping
- foreclosure
- fraud
- identity theft
- lender
- loan servicing
- loan-to-value (LTV)
- option ARM
- mortgage loan originator (MLO)
- predatory lending
- real estate owned (REO)
- Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)
- subprime loan

Overview

Everyone wants to own a home. After high-tech stocks failed in 2000, investors sought stronger returns on their investments and looked to real estate investments to provide them. And why not? Financial consultants have long touted the advantages of investing in real estate, whether as a homeowner or as an investor. In addition, residential sales and mortgage lending were fueled by nearly unprecedented home appreciation values and the lowest interest rates in 40 years.
By 2007, the real estate bubble burst. Property values had continued to rise, often fueled by the fraudulent practices in mortgage lending discussed in Chapter 3. The collapse resulted in the greatest recession since the Great Depression. Borrowers defaulted due to mortgage fraud and because of massive job layoffs. Lenders, who had loaned the money to acquire these homes, started to foreclose, initiating the legal process by which they acquired the property used as collateral for the borrower’s loan. The millions of foreclosures resulted in trillions of dollars of lost equity from the inflated home values just a few years earlier. The sheer number of real estate owned (REO) or bank-owned properties placed on the market caused housing prices to plummet in many localities.

Clearly markets vary, but some housing markets suffered more than others, especially those in the states of Florida, California, Nevada, and Arizona. By 2010, housing values began to drop in Chicago, Illinois; Minneapolis, Minnesota; and Seattle, Washington. The 2010 federal tax credit for first-time buyers offered a slight glimpse of hope, but after it expired, prices continued to fall. Because lending criteria, discussed in Chapter 2, has become more stringent, fewer buyers can meet the criteria and cannot take advantage of the low home prices. Nearly every real estate transaction involves the participation of the consumer with one or more of the following professionals: real estate licensees, lenders, appraisers, title insurance companies, and closing agents. In a perfect world, each has a legitimate role assisting the consumer in the purchase or sale of a property, and each plays a part in maximizing real estate opportunities.

Profits are made at every step of the transaction. Lenders and mortgage originators receive a percentage of each loan they make. Typically, real estate developers and their agents receive a percentage of each sales price. Appraisers, licensed individuals who assign market values usually at the request of the lenders, are kept busy and make a fee from each appraisal they perform.

However, with every opportunity comes a potential dark side: the possibility of fraud, because there are so many places in the mortgage loan process into which fraud can be committed. In today’s sliding economy, when homebuyers are scarce, real estate and mortgage-finance professionals may be desperate for business and thus more likely to cut corners. At the first Valuation Fraud Symposium in October 2006, Bill Stern, supervisory special agent and mortgage fraud coordinator for the FBI, warned participants that, in 2005, mortgage fraud and valuation fraud caused losses exceeding $1 billion. This estimation was merely a drop in the bucket. By 2009, the FBI estimated that more than $14 billion fraudulent loans were originated in that year alone. More than half involved FHA loans; the others were conforming loans. The FBI reported a 71-percent increase from fiscal year (FY) 2008 to FY 2009 in pending mortgage fraud investigations. Moreover, law enforcement sources report significant increases in gang members, organized criminal groups, domestic extremists, and the resurgence of debt elimination/redemptions schemes.

Investors intent on acquiring more profit with less investment will always find ways to capitalize on opportunities in the market, even if that means enlisting the aid of unethical professionals. Some of the more blatant fraudulent practices, such as the exotic loans discussed in Chapter 3, have been discontinued, but predatory lending and illegal flipping continue. Several newer schemes are discussed in Chapters 5 and 6.

Although appraisers may not base their fees on a percentage of the appraised value, many report being pressured to “come up with” inflated values or risk
being **blacklisted** (i.e., taken off someone’s recommendation list and prevented from obtaining any future business from that hiring party). Although the 2009 Home Valuation Code of Conduct (HVCC) was meant to prohibit lenders and third parties from influencing the work of the appraiser and influencing the appraised value, the appraisals remained flawed. The HVCC was phased out by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The **Dodd-Frank Wall Street Reform and Consumer Protection Act**, a reform bill that impacts in many areas of financing, became effective April 1, 2011. Among other financing reforms in the bill, Title XIV—Mortgage Reform and Anti-Predatory Lending Act addresses residential mortgage loan organization standards, minimum standards for mortgages, high-cost mortgages, and standards for appraisals.

With regard to appraisals, the following are now required:

- Appraisers and appraisal management companies may not have a financial interest in the properties they are appraising.
- Creditors may not extend credit based on appraisal if they know ahead of time that the appraiser was coerced or had a conflict of interest, unless the creditor recognizes that the appraised value is not materially misstated.
- Appraiser misconduct reports must be filed with appropriate state licensing authorities (creditors or settlement service providers are responsible for reporting).
- Reasonable and customary compensation must be given to appraisers who are not employees of the creditors or the appraisal management companies hired by the creditors.
- The act prohibits coercion designed to cause appraisers to base the appraised value on factors other than their own independent judgment.

**Real-Life Example**

In July 2010, four appraisers were indicted in Western Pennsylvania for their participation in a mortgage fraud scheme involving thirteen others and fraudulent loans exceeding $233 million. The appraisers admitted to placing their names on appraisals they did not perform and overstatement of property values. Three face up to 20 years imprisonment and/or a fine up to $250,000. The fourth appraiser faces up to 28 years in prison and/or a fine of $3.5 million.

Until 2009, it was relatively simple to enter the mortgage lending business. In some states, licenses were granted with payment of a fee. Even drug dealers have been involved in mortgage fraud activities to launder money through shady real estate investments. Such individuals take advantage of the myriad opportunities to borrow very cheap money and often use the depersonalization of loan applications (especially via the Internet) to create schemes to get more for less.

Fraud is a serious issue and a serious crime. White-collar crime involving real estate has consequences not only for the perpetrators and their victims, who will be affected for the rest of their lives, but also for financial institutions and entire communities which have seen their tax bases eroded due to the numbers of foreclosed properties. Headlines and news articles across the country reveal the dozens of criminals who have been rounded up for each big case. Those committed to fraudulent activities continue to find new ways to take advantage of consumers. In part, the need for expediency and the use of the Internet allows freer access to financial information and allows criminal activities to flourish.
Collaboration or Collusion of Industry Insiders

Although technology and the Internet allow for anonymity, fraudulent lending is difficult for just one industry insider to perpetrate through his own actions. More than 80 percent of all reported fraud losses involve the collaboration or collusion of industry insiders. Logistically, at least one other industry insider must participate or have knowledge of the illegal activity for it to succeed.

Sometimes professionals stumble into illegal, fraudulent transactions by accident, and by the time they realize what is going on, they may be too involved and too frightened to contact authorities. This is certainly the case with new and inexperienced appraisers, who often feel pressured into providing an acceptable appraisal if they expect to be hired again and not be blacklisted.

Real estate licensees are conditioned to work only within their areas of expertise. They are repeatedly told to avoid the unauthorized practice of law and cautioned that their real estate license does not permit them to make appraisals. They are constantly told that only lenders can make lending decisions. As a result, while real estate licensees may suspect a problem, many are reluctant to question the professionals too much.

When fraudulent schemes are uncovered, nearly everyone involved has lost something: the buyers lose their homes, the lenders their money, and the appraisers and real estate licensees their licenses and credibility. Many pay fines, and some even serve time in prison. Throughout this book, you will see real-life examples of fraudulent schemes and of the consequences for the perpetrators.

Good professionals—the honest ones—rise to the top with good leadership, ethics, and education. There is no gray area. Each person is on one side or the other of a thin black line. Once indicted, arguing that everyone does it or I was just cutting corners in a gray area will get you nowhere.

Mortgage Fraud in the United States

Fraud is the intentional misrepresentation of material facts with the intent to deceive and benefit from the advantage gained from the lie. Mortgage fraud occurs whenever someone misleads the lender to obtain a loan. Misleading events can include the following:

- Inflated appraisals
- False identities
- Incorrect verification of income and rental history
- False intent of occupancy
- Double HUD closing statements

The subprime mortgage market (discussed in more detail in Chapter 4) caters to those borrowers with, among other things, less than perfect credit, difficult to prove income, and spotty employment histories. Since subprime loans are often considered to be creative (i.e., meeting less stringent guidelines with respect to credit, income, and other historically typical qualifying criteria), abuses of subprime loans have become popular for unscrupulous borrowers and real estate investors. However, subprime lending opened the doors for home ownership to many who could not have obtained a home otherwise. Unfortunately, about half of subprime
loans made between 2001 and 2006 resulted in bankruptcy or foreclosure. Subprime loans were virtually nonexistent by the end of 2007.

**1974–1975**

Fraudulent activities led to many FHA and VA foreclosures in 1974–1975, primarily in low-income black urban neighborhoods. African Americans had had little access to FHA loans prior to the passage of Title VIII of the Civil Rights Act of 1968 (commonly referred to as the Fair Housing Act), and FHA loans were attractive alternatives to conventional loans because the credit guidelines were more liberal than those of conventional lenders and the loans were insured.

During the blockbusting sprees of the late 1960s and early 1970s, real estate licensees and speculators turned to FHA-insured and VA-guaranteed loans to facilitate their operations. Both the real estate community and lenders offering FHA and VA loans profited greatly. Unfortunately, with the recession of 1974–1975, many low-income borrowers lost their jobs and could not meet their payments. They then learned that many of the original appraisals had been inflated and this, coupled with the downturn in the economy, prevented them from selling their homes. Both the FHA and VA foreclosed early and often, seldom providing any counseling for the low-income borrowers, most of whom were African Americans.

**2000–2005**

Fast-forward 25 years, and FBI data shows a substantial increase in cases reported to the agency. In 1997, there were 1,778 cases reported and $46 million in losses. By 2005, that number had jumped to 21,971 cases and losses in excess of $1 billion. By 2009, 67,190 Suspicious Activity Reports (SARs) were submitted to the FBI.

The Mortgage Asset Research Institute (MARI) Fraud Index (MFI) is a statistical analysis of variations from expected fraud rates. The top ten states in 2009 are ranked in Figure 1.1.

**Figure 1.1 | Top Ten MARI Fraud Ranking by State (2005–2009 All Originations)**

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Note: The rankings are based on the mortgage fraud index, which is the variation from a statistical average of expected fraud rates.

Researchers estimate that the probability of default was at least six times higher for nonprime loans than for prime loans. Not only were subprime loans more likely to default, they also were doing so much earlier, often within the first six months.

**Effects of Foreclosures**

When mortgage payments are not made, lenders seek to recover their losses by foreclosing on the property. The costs of foreclosures to society are huge. Boarded-up homes contribute to a negative feeling about a neighborhood and make finding buyers more difficult. Tax appraisals are lowered and the tax base erodes, which produces less money to enhance community services, and the cycle continues downward.

Statistics show that every foreclosed property directly lowers property values within one-eighth of a mile. According to detailed studies in Chicago neighborhoods, each foreclosure decreases single-family home values by 0.9 percent to 1.44 percent. Each additional foreclosure further reduces property values by almost 1.8 percent.

The authors of *There Goes the Neighborhood* pointed out that policymakers should consider the implications:

> These costs are not just borne by individual homeowners and lenders, but also by communities—many of them lower-income and working class neighborhoods—who have no direct role in the mortgage lending process. This study shows that irresponsible lending has real implications for communities and cities—implications that can be measured, at least partially, in lost wealth and a decreased property tax base.

**Real-Life Example**

Former gang member Bobbie Brown Jr. was sentenced to 20 years in prison and ordered to repay $34 million in restitution as a result of one of the largest mortgage fraud cases in the history of Chicago. Brown and more than 30 accomplices used stolen Social Security numbers and straw purchasers to fraudulently obtain mortgage loans in Illinois, Nevada, and California. Brown's schemes involved builders, buyers, appraisers, loan officers, real estate agents, and lawyers, who were also charged.

One community that felt the effects was Frankfort, Illinois. Between 2004 and 2006, the ten homes that Brown purchased in Frankfort improperly inflated home values and, therefore, property taxes. Although Brown and some friends moved in, they did not pay the mortgages and engaged in activities that caused increased police activities in the suburb. Eventually, the homes were boarded up. Frankfort was left to deal with not only empty homes but also decreased property values and lower tax revenues.

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Possible Factors Leading to Foreclosures

If any one factor could be isolated to explain the mortgage market crisis, steps could be taken to prevent future occurrences and possibly cure the present dilemma. Analysts agree that part of the problem is caused by the national economic climate, while other problems are more local and can be addressed. The unfortunate fact is that after numerous studies, no single factor has been isolated as a primary cause—and without a cause, it’s difficult to find a cure.

Effect of Credit Scores

Another major anomaly is research into credit scores. The foreclosure debacle was assumed to be the result of subprime lending (i.e., lending to borrowers who had less than sterling credit). According to researcher Yulia Demanyank, an economist at the Federal Reserve Bank of St. Louis, subprime loans also include loans made to prime borrowers but secured with subprime mortgage loans, such as a 2/28 ARM. Sometimes the 2/28 ARM is called an exploding ARM because the initial low, teaser rate exists for only two years, after which it resets to a much higher rate.

Demanyank points out that only 2–5 percent of loans originated between 2001 and 2005 became delinquent in the first two years, but 18 percent of those originated in 2006 were past due or in foreclosure within one year. It didn’t matter whether the borrower provided full or no documentation or whether the loan was a hybrid or a fixed-rate mortgage. In the later years, the higher the credit score was, the larger the delinquency rate.\(^3\) See Figure 1.2 for information on the serious delinquency rate of subprime loans.

Certainly, the crisis of credit that brought about exotic loan programs discussed in Chapter 2 had a great impact. As more buyers entered into the transaction with little or no down payments (i.e., high loan-to-value [LTV] loans), they had less “wiggle room” when they tried to sell, which was a problem when they were forced to sell because of job loss or relocation. Although bad loans can lead to foreclosures, the latest round of foreclosures can also be traced to massive job layoffs. A lack of jobs certainly can lead to loss of homes. Other possible causes of foreclosure include the high rate of divorce, adjustable-rate mortgages, and even legalized gambling. Statistically, states with a great number of second homes—Colorado, Nevada, and Florida—were hit with the most foreclosures.

Personal Bankruptcy

The 2005 bankruptcy reform law shut the door on filing bankruptcy to avoid mortgage foreclosure. Under the automatic stay provision, consumers who want to file for protection from their creditors must receive credit counseling for 180 days prior to filing for either Chapter 7 or Chapter 13 bankruptcy. During this time, lenders are free to pursue any collection efforts, and consumers are expected to work out payment plans with creditors.

If the foreclosure is set for any time prior to the end of those 180 days, it is quite possible that the homeowner will not be able to file for bankruptcy protection before selling the home and, therefore, will lose the home. However, because lenders do not want to end up holding a property, they are generally amenable to

working out a payment plan to avoid the foreclosure process (i.e., a loss mitigation plan) if the title holder approaches them in time.

The real estate industry faces a real challenge when personal bankruptcy is involved. Often, real estate licensees cannot list properties for the prices that the sellers may need because sellers are overencumbered with loans that are higher than the value of their home. Buyers are unwilling to pay the inflated prices that the seller requires, and many buyers may not even be able to qualify for the loan required.

**Poor Loan Servicing**

A loan offers two profit centers: interest on the principal and loan servicing (i.e., the costs of handling the mortgage payments). Most loans are quickly sold after closing, and the servicing rights closing and the servicing rights are outsourced to a specialty company. **Servicing a loan** involves collecting the payments each month and then passing the principal and interest received from the borrower to the owner of the note. The servicer keeps a portion of the payment for the service it provides.
Servicing companies perform some or all of the following tasks, on behalf of the owner of the mortgage loan:
- Collect and credit monthly principal and interest payments
- Contact borrower when payment is late or not made
- Assess and collect late fees
- Establish escrow accounts to hold property taxes and hazard and flood insurance payments
- Pay property taxes and hazard and flood insurance policies
- Collect, hold, and pay for private mortgage insurance (PMI)

Other servicing responsibilities include working with the borrower to get payments back on track if the mortgagor becomes delinquent. In this last crisis, it has emerged that the expectation or obligation for the loan servicer to work with the borrower is actually a potential conflict of interest, one that has been highlighted as more and more mortgagors face foreclosure. Loan servicers have not been helpful when borrowers fall behind with their mortgage loan payments. The Department of Housing and Urban Development (HUD) reports that complaints about mortgage servicers have risen from 31 percent in 2006 to 78 percent in 2008. Although borrowers can choose their lenders, it is the lender who chooses the servicing company.

Many borrowers have complained that they were brushed off when they notified the servicing company of financial difficulties. One FDIC study notes a direct correlation from 1980 to 1998 between conventional foreclosure rates and the share of mortgages not serviced by the owners of the notes. Very possibly, if the owner of the note is also the servicer of the loan, borrowers have a better chance of working out an arrangement when they get behind on payments.

According to Jack M. Guttentag, professor of finance emeritus at the University of Pennsylvania’s Wharton School, “Predatory servicing has attracted little attention, yet in many respects it is more vicious and the adverse consequences are more far-ranging.” Although the Real Estate Settlement Procedures Act, or RESPA (discussed in detail in Chapter 6) requires loan servicers to deliver a servicing transfer statement at least 15 days before a transfer informing borrowers where to send payments, borrowers complain that they do not receive such notifications, much less receive statements of payments. They continue to make payments to the old company, which merely returns their checks. Eventually, the checks make it to the new servicer, who marks the payment late, deducts late fees, and then records the payment as underpaid.

Ocwen Financial Corporation is the nation’s third largest third-party servicer and the fourth-largest servicer of nonprime mortgage loans. Not only does Ocwen service mortgage loans, it also markets foreclosed properties (see www.ocwen.com). The company has been the subject of a number of individual lawsuits. One plaintiff received $11.5 million when a jury found the company guilty of fraud in servicing her home equity loan. Ocwen is still in business, although in May of 2009, Judge Elizabeth Magner imposed new accounting procedures after

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6 Ibid.
finding that Ocwen tried to collect fees it was not owed in one out of every six cases (McKain v. Ocwen).

Ocwen is not the only company involved. In Nosek v. Ameriquest, the court ordered Ameriquest to pay $250,000 in emotional distress damages and $500,000 in punitive damages. The judge stated, “As for punitive damages, the Court finds that Ameriquest’s accounting practices are wholly unacceptable for a national mortgage lender.”

Litton and H&R Block’s Option One have also been the subject of many lawsuits. These lawsuits are very similar to the class action lawsuit against Ocwen:7

- Failure to credit payments received in a timely fashion
- Failure to provide customers with timely or clear information about timing and amount of payments owed
- Premature referral of accounts to collections, regardless of legal and/or contractual grace periods
- Misapplication of payments received (escrow versus principal and interest)
- Increase in customers’ monthly payment amount without proper notice and in violation of the terms of the customers’ original mortgage note
- Procurement of hazard insurance for properties already insured, resulting in exorbitant annual premiums charged to customers’ accounts without cause

**ARM Adjustments**

Although fixed rate mortgages (FRMs) are the safest (or at least most predictable) type of mortgage loan, adjustable rate mortgages (ARMs) certainly have their place and continue to be offered. The FRM payments are the same for the life of the loan, while the ARM initially offers lower monthly payments that are increased at a certain point in time, often after three, five, or seven years, and then regularly thereafter. ARMs are particularly useful for those who need the initial lower payments or those who do not expect to stay in their homes more than five to seven years.

Those who should not enter in an ARM mortgage include those who do not qualify for a FRM for a higher priced home or because they think that mortgage rates will continue to be very low. Although low interest rates have been the norm for more than five years, they started to inch up at the end of 2010. According to the Mortgage Bankers Association, the number of ARMs peaked in 2004, when nearly 40 percent of residential loans were ARMs. This dropped to 3 percent in 2009 but is projected to reach 9 percent in 2011.

Unfortunately, many borrowers entered into option ARMs, under which the borrower was allowed to decide (given the option) the amount of the monthly payment. Many of the payments were minimal, which often did not even cover the interest, much less the principal. Sometimes, the initial teaser rate was as little as 1 percent. The shortfall was added to the principal, resulting in negative amortization. In other words, the payments they made did not touch the principal, and the borrowers now owe more than they originally borrowed. These ARMs started to reset in 2009, by which time nearly a third were in default or foreclosure. It is estimated that the fallout from option ARMs will dwarf those from subprime loans.

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7 See www.lieffcabraser.com/ocwen.htm.
For many mortgagors, payments will dramatically increase, often by hundreds of dollars a month. Some borrowers will be able to absorb the higher payments; others will not and will have to put their homes on the market. Some of these homes will not sell for the amount owed, thus requiring their owners to bring money to closing. Still others will be unable to make the payments or to sell their homes at all. They face foreclosure.

**Real-Life Example**

The story of Randy and Jennifer Rimstad of Minnetonka, Minnesota, illustrates what can happen when ARM payments escalate. After living in their home for 24 years, the Rimstads refinanced in 2004 with an ARM to get money to replace a 50-year-old furnace and give their daughter a nice wedding. In May 2006, their interest rate adjusted from 5.55 percent to 8.55 percent, and their monthly payments increased from $1,654.81 to $2,295.68. When they couldn’t meet these payments, Option One, their servicer, tacked on another $700 a month to cover collection fees. By December 2006, they owed Option One more than $18,000 in late fees and attorney’s fees in addition to their past-due payments.8

**Identity Theft**

Identity theft consists of obtaining personal identifying information, such as a person’s Social Security number, credit card numbers, and other personal information, and then using that person’s name and credit history to obtain a loan or to acquire benefits without that person’s knowledge or permission. Stolen identities are a major part of the problem when it comes to mortgage and real estate fraud. Once someone’s identity is stolen, the thief can use the information to obtain loans in the name of the stolen identity and never make a payment. The Federal Trade Commission has published an excellent brochure about identity theft, showing how it can happen, how to avoid it, and how to defend yourself if it occurs. Identity theft is discussed in greater detail in Chapter 3.

Some schemes involve loan officers who turn down applicants but then retain and doctor the basic information. They resubmit the application, obtain a loan, and abscond with the funds. In these cases, not only are borrowers’ identities stolen, but also the names of honest and legitimate appraisers and loan originators are used in falsified appraisals and loan applications.

**Mortgage Fraud and Illegal Flipping Schemes**

Real estate investors have always flipped properties. Flipping involves purchasing a property at a low price and selling it at a higher price. However, when the mortgage applications for these properties include falsified information and inflated appraisals, it constitutes fraud. Illegal flipping is discussed in greater detail in Chapter 5.

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COMMON WAYS ID THEFT HAPPENS:

Identity thieves use a variety of methods to steal your personal information, including:

1. Dumpster Diving. They rummage through trash looking for bills or other paper with your personal information on it.

2. Skimming. They steal credit/debit card numbers by using a special storage device when processing your card.

3. Phishing. They pretend to be financial institutions, companies or government agencies, and send email or pop-up messages to get you to reveal your personal information.

4. Hacking. They hack into your email or other online accounts to access your personal information, or into a company’s database to access its records.

5. “Old-Fashioned” Stealing. They steal wallets and purses, mail, including bank and credit card statements, pre-approved credit offers, and new checks or tax information. They steal personnel records from their employees, or bribe employees who have access.

To learn more about ID theft and how to deter, detect, and defend against it, visit ftc.gov/idtheft. Or request copies of ID theft resources by writing to:

Consumer Response Center
Federal Trade Commission
600 Pennsylvania Ave., NW, H-130
Washington, DC 20580

May 2010
Identity theft is a serious crime. It occurs when your personal information is stolen and used without your knowledge to commit fraud or other crimes. Identity theft can cost you time and money. It can destroy your credit and ruin your good name.

Deter identity thieves by safeguarding your information.

- Shred financial documents and paperwork with personal information before you discard them.
- Protect your Social Security number. Don’t carry your Social Security card in your wallet or write your Social Security number on a check. Give it out only if absolutely necessary or ask to use another identifier.
- Don’t give out personal information on the phone, through the mail or over the Internet unless you know who you are dealing with. Avoid disclosing personal financial information when using public wireless connections.
- Never click on links sent in unsolicited emails; instead, type in a web address you know. Use firewalls, anti-spyware and anti-virus software to protect your home computer; keep them up-to-date. If you use peer-to-peer file sharing, check the settings to make sure you’re not sharing other sensitive private files.
- Keep your personal information in a secure place at home, especially if you have roommates, employ outside help or are having work done in your house.

Detect suspicious activity by routinely monitoring your financial accounts and billing statements.

Be alert to signs that require immediate attention:
- Bills that do not arrive as expected
- Unexpected credit cards or account statements
- Denials of credit for no apparent reason
- Calls or letters about purchases you did not make
- Changes on your financial statements that you don’t recognize

Inspect:
- Your credit report. Credit reports contain information about you, including whether accounts you have and your bill paying history. The law requires the major nationwide credit reporting companies—Equifax, Experian, and TransUnion—to give you a free copy of your credit report every 12 months if you ask for it.
- Visit www.AnnualCreditReport.com or call 1-877-322-8228, a service created by these three companies, to order your free annual credit report. You also can write: Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281.
- If you see accounts or addresses you don’t recognize or information that is inaccurate, contact the credit reporting company and the information provider. To find out how to correct errors on your credit report, visit ftc.gov/idtheft.

Defend against ID theft as soon as you suspect it.

- Place a "Fraud Alert" on your credit reports, and review the reports carefully. The alert tells creditors to follow certain procedures before they open new accounts in your name or make changes to your existing accounts. The three nationwide consumer reporting companies have toll-free numbers for placing an initial 90-day fraud alert, a call to one company is sufficient:
  - Experian: 1-888-EXPERIAN (397-3742)
  - TransUnion: 1-800-680-7289
  - Equifax: 1-800-525-6285

Placing a fraud alert entitles you to free copies of your credit reports. Look for inquiries from companies you haven’t contacted, accounts you didn’t open and debts on your accounts that you can’t explain.

- Contact the security or fraud departments of each company where an account was opened or charged without your okay. Follow up in writing, with copies of supporting documents.
- Use the ID Theft Affidavit at ftc.gov/idtheft to support your written statement. Ask for verification that the disputed account has been dealt with and the fraudulent debts discharged. Keep copies of documents and records of your conversations about the theft.

- File a police report. File a report with law enforcement officials to help you correct your credit report and deal with creditors who may want proof of the crime.
- Report the theft to the Federal Trade Commission. Your report helps law enforcement officials across the country in their investigations.

Online: ftc.gov/idtheft
By phone: 1-877-ID-THEFT (438-4338) or TTY, 1-866-653-4261
By mail: Identity Theft Clearinghouse, Federal Trade Commission, Washington, DC 20580

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Figure 1.3 | "Avoid Identity Theft” Brochure (continued)
**Real-Life Example**

One loan originator writes the following:

*I realized I had uncovered a scheme that involved something similar to this: purchase property for $1.2 million, appraise it for $3.5 million, sell it the same day to a “borrower” for $3.5 million and pay the original seller his $1.2 million from the “borrower’s” 80-per-cent mortgage on the $3.5-million purchase price. This “business venture” left $1.6 million on the table to be split up amongst the involved parties—per deal! They would escrow 18–24 months of payments, keep the properties insured, and no one was the wiser. In addition, they were creating their own market. Each deal would become easier to appraise because of the comparable sale created by the transaction that has just closed. It was brilliant.*

**Predatory Lending**

Predatory lending consists of practices that, although legal, are not in the best interests of the borrower. Predatory lending occurs when lenders target people who may not have access to sound real estate or financial advice. A victim of predatory lending is someone who is charged a higher-than-market interest rate or higher-than-normal closing costs. Victims are often senior citizens who have built up equity in their homes, low-income buyers, buyers with low credit scores, immigrants, and buyers of manufactured housing. By the time the scheme is uncovered, many honest people have lost their original investments, their homes, and their credit scores. Immigrants, who are buying homes at an unprecedented rate, appear to be more vulnerable to being misled by unscrupulous real estate agents, lenders, and appraisers. Predatory lending is discussed in greater detail in Chapter 4.

**Increasing Regulation**

Licensing is one obvious method of managing the actions of professionals. Most states require that professionals be licensed, including for real estate agents, appraisers, and attorneys. After the 1980’s appraising debacles, the appraisal industry underwent vast changes with the institution of rigorous licensing guidelines, extensive peer review of sample appraisals, and a 15-hour code of ethics class created by the Appraisal Foundation.

**Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)**

According to HUD, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) is expected to enhance consumer protection and reduce fraud by establishing minimum requirements for the licensing and registration of mortgage loan originators (MLOs). Each state was required to have a licensing and registration system in place by July 31, 2010. A state may exceed the standards, but must meet the minimum standards. HUD will administer the licensing for states that do not meet the minimum standards.

A mortgage loan originator (MLO) is an individual who, for compensation or expectation of compensation, takes a residential mortgage loan application or offers or negotiates terms of a residential mortgage loan. Anyone who solicits a mortgage loan, by phone or in person, must be licensed in the state where the

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property is located, not where the phone call originates or where the MLO lives. Exemptions include

- those who perform only clerical or administrative tasks in connection with loan origination are exempt;
- real estate brokerage activities unless the licensee is compensated by a loan originator;
- loan processing or underwriting undertaken under the direction and supervision of a state-licensed loan originator or registered loan originator; and
- individuals solely involved in extensions of credit relating to timeshare plans.

Minimum standards include at least the following:

- Criminal history background check
- Individual credit check
- Education prior to licensure
- Examination prior to licensure
- Required continuing education
- Individual net worth requirement
- Individual surety bond (fees normally between 1–2 percent of the bond amount)

SAFE encourages, but not does not require, that each state participate in the establishment of a Nationwide Mortgage Licensing System and Registry (NMLS) in order to enhance consumer protections and support anti-fraud measures (see http://mortgage.nationwidelicensingsystem.org). The NMLS facilitates the collection and disbursement of consumer complaints so that state and federal regulators can share information.

**Value of Education**

With the increased scrutiny on mortgage lending, it is difficult to understand why there is an increase in fraudulent activities. In *Doing the Right Thing: A Real Estate Practitioner’s Guide to Ethical Decision-Making*, author Deborah Long postulates that it is possible that participants in illegal activities got into trouble not because they were criminals but because

(a) they were either unaware of or did not fully understand the rules, regulations, and/or laws they violated…or (b) although not career criminals, they were aware of the rules, regulations, and laws and violated them knowingly or (c) although aware of the rules and laws, poor judgment caused them to make bad decisions regarding their professional behavior.

Thus, education is critically important. The informed real estate licensee may not be able to protect consumers from their own uneducated financial decisions. However, as real estate professionals become more aware of possible fraudulent schemes, they may be in the unique position to assist consumers to recognize and avoid not only foolish financial decisions but also participation in illegal activities.
Summary

Real estate transactions take place through the efforts of any number of people: real estate licensees, lenders, appraisers, and mortgagors. From 2001 to 2005, housing values were high, interest rates were low, lender competition was fierce, and loan products were innovative. Everyone wanted to participate, and not everyone was honest.

Reports from the FBI and MARI indicated that mortgage fraud, predatory lending, and illegal flipping continue. The effects of the resultant foreclosures affect not only the lenders who must absorb billions in losses but also legitimate buyers and sellers, entire neighborhoods, and community plans based on property taxes.

Foreclosures continue to increase for a variety of reasons: borrowers are in over their heads with low or no down payments and very high LTV loans, adjustable interest rates, divorce, and legalized gambling. However, when tracked, only two issues bear a similar correlation: personal bankruptcy, double HUD statements, and the numbers of mortgages not serviced by the owners of the notes. Illegal activities leading to foreclosure include identity theft, mortgage fraud, illegal flipping schemes, and predatory lending.

Recent legislation requires that appraisers must not be coerced when determining market value. They must be compensated reasonably and fairly, but never based on the appraised value.

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case study

Case Study A

A real estate licensee meets a potential buyer at an open house. After a thorough discussion with this prospect, the licensee believes he understands her basic financial situation and believes that she is a viable buyer. She signs a purchase agreement to buy the home for $200,000 and is now ready to get a loan to finance her purchase.

The buyer walks into a mortgage office and fills out a loan application with a loan originator. The loan originator then refers the appraisal to an appraiser and tells him, “Sharpen your pencil, we need to make this loan.” After a thorough appraisal, the appraiser arrives at a value of $180,000.

1. Under recent legislation, what license, if any, is the loan originator required to have?
   a. No license
   b. Underwriter’s license
   c. No license, but she must register as a loan officer
   d. Mortgage loan originator (MLO) license

2. All of the following would like the higher $200,000 appraisal EXCEPT
   a. the buyer.
   b. the loan officer.
   c. the seller.
   d. the real estate licensee.
Please provide your comments regarding the basic principle(s) addressed in this case study and its general relevance to the subject matter.
Chapter 1 Review Questions

1. In the last decade, real estate has become attractive to investors because of
   a. slow appreciation rates.
   b. low interest rates.
   c. reverse redlining.
   d. identity theft.

2. What is MOST likely a result of the 2005 Bankruptcy Reform Act on the mortgage industry?
   a. Increase in the number of foreclosures
   b. Decrease in the number of foreclosures
   c. Little or no effect on foreclosures
   d. Increase in the value of foreclosed properties

3. Between 2005 and 2010, mortgage fraud cases tracked by the FBI have
   a. slowly increased.
   b. dramatically increased.
   c. slowly declined.
   d. rapidly declined.

4. What is the effect of large numbers of foreclosures hitting the market?
   a. Sellers have more options.
   b. Neighborhoods flourish.
   c. Buyers have few options.
   d. Property values decrease.

5. Of the following, who is required to acquire a surety bond before obtaining a license?
   a. Real estate licensees
   b. Appraisers
   c. Mortgage loan originators (MLOs)
   d. Underwriters

6. Who is required to be licensed as a mortgage loan originator (MLO)?
   a. A person who negotiates a loan with a consumer
   b. A real estate licensee who explains to a buyer the difference between a fixed rate loan and an adjustable rate loan
   c. Any party who determines the value of the home that will secure the property
   d. A person arranging credit for a time share purchase

7. All of the following are minimum standards required of mortgage loan originators (MLOs) EXCEPT
   a. a criminal history background check.
   b. an individual net worth requirement.
   c. education and examination.
   d. a physical exam.

8. An appraiser may come up with an inflated home value
   a. to make the buyer happy.
   b. because the appraiser’s fee is based on a percentage.
   c. to appease the seller.
   d. to avoid being blacklisted.

9. Which of the following is required by the SAFE Act of 2008?
   a. Appraisers must be employed by an appraisal management company.
   b. Minimum licensing requirements are required for mortgage loan originators.
   c. States are required to participate in the Nationwide Mortgage Licensing System and Registry.
   d. Mandatory federal licenses are required for mortgage loan originators.

10. The FBI has calculated that 80 percent of all fraud losses are due to
    a. innocent processing errors.
    b. buyers who panic because they may never be able to afford a home.
    c. collaboration of industry insiders.
    d. organized crime, including the Mafia and drug cartels.
Mortgage Fraud and Predatory Lending:
WHAT EVERY AGENT SHOULD KNOW
SECOND EDITION

Mortgage fraud is all too common in today’s market. This second edition includes updated information on the fraudulent practices that contributed to the recent influx of home loan defaults, foreclosures, and bank-owned properties.

Features
• Provides concise overviews of the laws intended to prevent fraudulent practices
• Includes real-life cases and examples in every chapter
• Tests mastery of the material with multiple-choice chapter quizzes
• Reinforces important vocabulary through key terms and a comprehensive glossary

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Title Insurance for Real Estate Professionals
Understanding 1031 Tax-Free Exchanges

Professional Development & Reference
21 Things I Wish My Broker Had Told Me
Real Estate Investor’s Tax Guide
The Big Book of Real Estate Ads
The Language of Real Estate
Up and Running in 90 Days