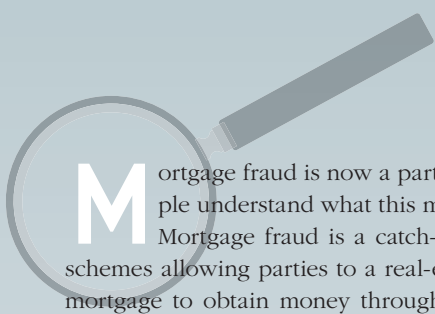


# Recognizing Mortgage Fraud



By Howard A. Lax



**M**ortgage fraud is now a part of our lexicon, but few people understand what this means and the harm it causes. Mortgage fraud is a catch-all phrase that encompasses schemes allowing parties to a real-estate transaction involving a mortgage to obtain money through illegal or unethical means. Mortgage fraud cost us, as a society, somewhere between \$946 million and \$4.2 billion in 2006,<sup>1</sup> and the cost will increase.

Residential mortgage transactions are particularly susceptible to fraud, since the mortgage lending industry relies on patterned transactions to simplify home sales and mortgage financing with as little cost and time as possible. In a “normal” residential sale transaction, the buyer, seller, and real-estate broker(s) negotiate a sale using a model purchase agreement. The buyer meets with a loan officer from a mortgage broker or lender, and chooses a standard loan product to finance the transaction. The lender obtains an appraisal of the property and a credit report for the borrower. After loan approval, the lender obtains a title insurance commitment. A closing agent (usually a title insurance agency) accounts for the parties’ funds, distributes the proceeds of the transaction, arranges for recording the mortgage, and issues title insurance policies for the buyer and lender. The lender sells the loan to an investor, and the borrower makes monthly payments to the servicing agent selected by the investor. Because the documents and the roles of the parties are very uniform, nobody performs much due diligence. Hence, it is relatively easy to interject false documents or parties into the transaction to obtain money.

Mortgage fraud schemes are extensive, ranging from the simple to the complex, and far too common. Some of the more common schemes are:

### **Inflated Income or Assets**

Recent audits by one lender found income significantly overstated in two-thirds of the applications submitted for credit on a “stated income” basis (i.e., where the borrower’s income is not verified). Sometimes the borrower borrows the down payment without revealing the obligation to repay it. The debt may be mischaracterized on the settlement statement as an unrecorded lien or as unidentified management services that are paid at closing. Making false representations in a loan application, providing false documents to verify income or assets, and knowingly processing a false loan application are crimes.<sup>2</sup>

### **False Social Security Numbers**

Borrowers sometimes use a stolen Social Security number or fake identification documents of a person with “good credit” to obtain a loan. More sophisticated thieves use a good Social Security number and a fake name (“synthetic ID theft”) to make it harder to detect and identify the thief.

### **Altered Documents**

W-2 forms, bank statements, title commitments, leases, tax returns, and all manner of documents used to verify income and asset information have been altered or forged. Fake employment verification forms can be purchased over the Internet. Some borrowers forge discharges from their prior lender or erase the loan from the schedule of exceptions on a title commitment to avoid paying the balance of their prior loan.

### **Multiple Loans**

Lenders rely on the credit report and title commitment to locate the borrower’s obligations. There is generally a “gap period” between the date that documents are submitted to the register of deeds for recording and the date they become available for inspection. There is also a gap on credit reports between the date of a loan payment (or a missed payment) and the date that information is listed in a credit report. Some borrowers close two or three re-finance loans on one property with different lenders during a “gap period,” knowing that the lenders and title agencies cannot find the other loan transactions.

## **FAST FACTS**

- Mortgage fraud costs us billions of dollars each year.
- Liar loans are destroying lenders.
- Under-the-table payments are illegal.
- Education, disclosure, detection, and enforcement are the keys to stopping fraud.

### Inflated Deposits and Soft Second Mortgages

Consumers with equity interests in their home are less likely to default on their mortgage payments. Hence, most loan programs require a down payment. A buyer may give a false purchase agreement to the lender, showing a false earnest money deposit and an inflated purchase price. Or, a buyer and seller sometimes inflate the purchase price of a home and offer seller financing in lieu of a down payment so that the buyer can obtain a larger loan than would be permitted by the lender's underwriting standards. The seller's note and mortgage are torn up after the closing.

### Identity Theft

The closing agent relies on the borrower's driver's license or other forms of identification to verify that persons who physically sign the deed, note, mortgage, and other documents have authority to sell the home and borrow money. In Michigan, a forged mortgage is void.<sup>3</sup>

### Straw Buyer

A real-estate investor may ask a friend or relative, or pay someone, to be a "straw buyer." The investor promises to make monthly loan payments and to pay off the loan within a year or two. In some cases, a land speculator purchases a home at a low price, and conspires with a straw buyer to sell the home for an excessive price. The proceeds are used to make monthly payments on the loan. Criminal liability for making a false loan application aside,

the straw buyer's credit rating is ruined when the investor stops making loan payments.

### Inflated Appraisal

The homeowner, seller, or mortgage broker may have an illegal arrangement with an appraiser to inflate the true value of the property, or may provide fraudulent comparable sales information to the appraiser, so that a loan will be approved for an amount that exceeds the home's market value.<sup>4</sup> The excessive valuation may be justified by fake pictures of the subject property, or property values from other fraudulent transactions.

### Money Laundering

It is very easy to prepare and record a forged deed. To launder money, a straw buyer uses illegally obtained funds to buy the home from the fake seller. The title agency unknowingly takes the illegally obtained funds, and issues its own check to the fake seller with good funds. The object of the transaction is to exchange the seller's funds to hide the trail of money to its illegal source.

### Foreclosure Rescue

Some real-estate "rescuers" offer to "help" homeowners in difficult financial situations; however, the real purpose of "saving" a borrower that nobody else considers a fair credit risk is to "strip" the homeowner's equity. A homeowner facing foreclosure may deed the home to a rescuer, who promises to sell it back at a higher price in a year or two through a land contract or lease with an option to purchase. The rescuer obtains a conventional loan to buy the home, and may even convince the homeowner to sign over to the rescuer the sale proceeds with the rescuer's promise to pay off other debts owed by the seller. The rescuer knows that the homeowner has no means of obtaining a new loan to buy the home back at its inflated price.

### Servicing Transfers

Federal law requires a lender to send a Notice of Transfer of Servicing to the borrower when mortgage payments must be sent to a new loan servicer.<sup>5</sup> Some thieves simply send a Notice of Transfer of Servicing, instructing the borrower to send mortgage payments to the thief.



## Flipping

Frequent sales of a property are not illegal. Higher sale prices may be justified when the property is rehabilitated. However, frequent sales at increasing prices between parties with a hidden relationship can make the property appear more valuable than it is. Sometimes the parties attempt to justify the price increase with cosmetic improvements that hide more serious problems. Flipping is often accomplished with the help of an improper appraisal and intentional misrepresentation of the condition of the property. Some flippers misrepresent that they own the property, or that the property is subdivided. These deceptions are sometimes assisted by a false title insurance commitment. The FBI website<sup>6</sup> highlights the case of a collapsed Detroit home sold one day for \$25,000, and the next day for 10 times that amount.

## Occupancy Fraud

Mortgage lenders require higher down payments for second homes and investment properties than for loans secured by a principal residence. To obtain better loan terms, borrowers sometimes state that a second home or investment property will become their principal residence after the closing.

## Inflated Credit History

Borrowers with poor credit payment histories may purchase the right to become a “co-borrower” on good credit accounts (“tradelines”). Good tradelines dilute the impact of the borrower’s poor tradelines and raise the borrower’s credit score. This scheme is not yet illegal. The national credit bureaus are working to identify these borrowers to eliminate the impact of purchased tradelines.

## Misleading Disclosures

Federal rules require disclosure of an estimate of closing costs within three days after a mortgage broker or lender receives a residential mortgage loan application.<sup>7</sup> Borrowers also receive an estimate of the annual percentage rate and monthly payments within three days after providing a purchase money loan application to a lender.<sup>8</sup> However, this information need not be redisclosed if the actual closing costs are different.<sup>9</sup> Some brokers provide disclosures for a “prime” loan, but arrange a “subprime” loan for a borrower, even though the borrower would qualify for a prime loan. This does not violate federal law, and the borrower is at fault for accepting a loan that is more expensive than the initial estimates.<sup>10</sup> However, engaging in fraud, deceit, or material misrepresentation is illegal.<sup>11</sup> A lender or broker violates state law if disclosures are provided for low-cost credit, or low-cost credit is promised, when such credit is known to be unavailable to the applicant.

## Required Use of Affiliates

A seller and his or her real-estate broker cannot require the borrower to use a particular title agency for the lender’s title policy if the buyer pays the insurance premium.<sup>12</sup> Hence, it is illegal to

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require a documentation fee if the buyer does not use the seller’s preferred title agency. It is also illegal to require a borrower to use the services of an affiliated settlement service provider if the borrower pays for the services.<sup>13</sup>

## Kickbacks

It is illegal to directly or indirectly pay or receive something of value under an agreement or understanding that the payment is for the referral of settlement service business.<sup>14</sup> It is also illegal to split a fee for settlement services without doing any work to earn a portion of the fee.<sup>15</sup> Some mortgage brokers, lenders, and title agencies find it more expedient to pay kickbacks “under the table” to assure business referrals than to generate business based on the merit of their services.

## Failing to Disburse

Some lenders wait until after the loan closes to finish underwriting a loan. If the borrower fails to meet underwriting requirements, or the loan cannot be sold at a profit, the lender refuses to fund the loan. State law requires that a lender satisfy its written lending commitments.<sup>16</sup> While mortgage brokers have no responsibility to provide a written loan commitment, borrowers may not know that they cannot rely on the mortgage broker’s oral representations.<sup>17</sup>

## Selling Fake Loans

Some unscrupulous lenders create documents for a loan that does not exist, and sell the loan to raise capital or hide losses. A lender may also sell a loan more than once to hide losses at the

company, or to satisfy credit obligations. The proceeds of the sale are used to make monthly payments to the loan purchaser.

### Closing Agent Defalcation

Licensed title insurance agencies are required to keep transaction funds in a trust account. However, there is no requirement that a notary closing service (a “signing service”) maintain trust accounts. Employees of signing services may steal these funds, resulting in the failure of the closing agent to pay transaction proceeds.

### What to Do?

Mortgage fraud succeeds because consumers do not understand residential transactions. Hence, we need to teach financial literacy to all consumers in the public school system. Financial literacy course materials, such as the Federal Deposit Insurance Corporation’s Money Smart program,<sup>18</sup> are freely available. The Mortgage Bankers Association is sponsoring a committee to write uniform residential closing instructions, which will require the closing agent to be a “gatekeeper” against mortgage fraud.

The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators recently proposed a uniform mortgage company and mortgage company employee licensing program to make licensing in multiple states easier and less costly, and to allow states to share information about bad actors within the mortgage industry.

Society should also better identify and prosecute those who break the law. Most of the mortgage fraud scams referenced in this article are already illegal under state or federal law or both.

Finally, consumer disclosures should be made understandable and meaningful. A recent Federal Trade Commission Bureau of Economics report<sup>19</sup> found that mandatory mortgage disclosures fail to convey key mortgage costs and terms. Disclosures should highlight information that really matters to the average home buyer. Some legislatures are proposing laws to prohibit unsafe or unsound lending practices, and practices that mislead consumers. Better disclosures and safer lending practices may help consumers avoid inappropriate real estate and loan transactions. ■

*The full length version of this article, including additional footnotes and hypertext links to source materials, is available at <http://www.michbar.org/realproperty/materials.cfm>.*



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### FOOTNOTES

1. Federal Bureau of Investigation, *Mortgage Fraud: New Partnership to Combat Problem*, March 9, 2007, available at <<http://www.fbi.gov/page2/march07/mortgage030907.htm>> (accessed October 17, 2007); Federal Bureau of Investigation, *2006 Mortgage Fraud Report*, May 2007, available at <[http://www.fbi.gov/publications/fraud/mortgage\\_fraud06.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud06.htm)> (accessed October 17, 2007) (listing Michigan as one of the top 10 states for mortgage fraud). Many publicized cases of mortgage fraud are detailed at [www.mortgagefraudblog.com](http://www.mortgagefraudblog.com).
2. See MCL 750.219, MCL 750.219(e), MCL 445.1634, MCL 445.1640; 18 USC 1014.
3. *McGinn v Tobey*, 62 Mich 252; 28 NW 818 (1886). See also *Forge v Smith*, 458 Mich 198, 206; 580 NW2d 876 (1998) (the absence of an owner’s signature renders a conveyance void).
4. See Office of the Comptroller of the Currency, *Independent Appraisal and Evaluation Functions*, October 28, 2003, available at <<http://www.occ.treas.gov/ftp/advisory/2003-9a.pdf>> (accessed October 17, 2007); Office of the Comptroller of the Currency, *Frequently Asked Questions on Residential Tract Development Lending*, September 8, 2005, available at <<http://www.occ.treas.gov/ftp/bulletin/2005-32a.pdf>> (accessed October 17, 2007).
5. See 24 CFR 3500.21(d).
6. See Federal Bureau of Investigation, *The Rise of Mortgage Fraud: And How It Impacts You*, December 14, 2005, available at <<http://www.fbi.gov/page2/dec05/mortgagefraud121405.htm>> (accessed October 17, 2007).
7. See 12 USC 2604(c); 24 CFR 3500.7 (Section 7 of HUD’s Regulation X).
8. See 12 CFR 226.18, 12 C.F.R. 226.19(a).
9. Federal Deposit Insurance Corporation, *U.S. Department of Housing and Urban Development’s Response to Questions from the Massachusetts Bankers Association*, July 12, 2000, available at <<http://www.fdic.gov/news/news/financial/2000/fil0045a.html>> (accessed October 17, 2007) (informal advice given to the Massachusetts Bankers Association by HUD published as Attachment A to FDIC Financial Institution Letter 45-2000).
10. *McCartney v Lakeside Community Bank*, unpublished opinion of the Michigan Court of Appeals, issued March 27, 2007 (Docket No. 272131). The court upheld summary judgment for the bank against the borrower’s claim that the bank made a “predatory” loan to the borrower. Citing *Isbell v Anderson Carriage Co*, 170 Mich 304, 312; 136 NW 457 (1912), the court stated that it “cannot relieve a party from the consequences of her contract simply because the agreement was ill-advised.”
11. MCL 445.1672(b).
12. See 12 USC 2608 (Section 9 of RESPA).
13. See 12 USC 2607(c) (Section 8(a) of RESPA); 24 CFR 3500.15(b)(2). There are exceptions to this rule.
14. See 12 USC 2607(a) (Section 8(a) of RESPA); 24 CFR 3500.14. A rebate to the borrower for accepting a loan is not prohibited by RESPA. State laws prohibit rebates by insurance companies and agencies. See MCL 500.2066, MCL 500.2070. Both the buyer and seller must consent to a closing that deviates from the terms of a written purchase agreement (e.g., by giving a rebate to one party). 1999 AC, R 339.22311(3).
15. See 12 USC 2607(b) (Section 8(b) of RESPA). HUD takes the position that marking up a fee is illegal, but federal circuit courts are split. Compare *Boulware v Crossland Mortgage Corp*, 291 F3d 261 (CA 4, 2002) (markup of a third-party fee without an agreement with the third party is not illegal) with *Kruse v Wells Fargo Home Mortgage, Inc*, 383 F3d 49 (CA 2, 2004) (identifying a third party in agreement with the markup is not needed to find a violation of Section 8(b) of RESPA).
16. See MCL 445.1672(k).
17. See MCL 566.132(2).
18. See Federal Deposit Insurance Corporation, *Money Smart—An Adult Education Program*, available at <<http://www.fdic.gov/consumers/consumer/moneysmart/overview.html>> (accessed October 17, 2007).
19. See Federal Trade Commission, *Improving Consumer Mortgage Disclosures*, June 2007, available at <<http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf>> (accessed October 17, 2007).