

**White Paper**

# **Mortgage Asset Research Institute**

Ninth Periodic Mortgage Fraud Case Report  
to Mortgage Bankers Association

April 2007

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Dear MBA Member:

Mortgage fraud continues to pose a significant and growing threat not only to lenders, but to homeowners and communities at large. Through education, research and advocacy, the Mortgage Bankers Association (MBA) strives to equip its members with the knowledge and tools necessary to catch and avoid fraud in their operations.

One such tool is the cooperative databases of the Mortgage Asset Research Institute, LLC (MARI). The most prominent of these is the Mortgage Industry Data Exchange (MIDEX), which is a database system where lenders, insurers and agencies exchange information about companies and parties that have originated loans containing fraud.

Enclosed, you will find the *Ninth Periodic Case Report to the Mortgage Bankers Association*, produced by MARI. MARI provides MBA members these annual reports as well as discounted fees to participate in MARI's database.

Mortgage fraud is a burgeoning crime that is affecting more and more companies and communities. As the *Case Report* indicates, recent statistics from the Federal Bureau of Investigation (FBI) and Financial Crimes Enforcement Network (FinCEN) illustrate just how quickly the problem is growing: Suspicious Activity Reports (SARs) related to mortgage fraud, for example, have risen from over 3,515 in FY 2000 to over 28,000 in FY 2006, representing estimated losses of about one billion dollars. It is important to note that this likely represents only the tip of the iceberg, as SARs are only required to be filed by federally-regulated institutions.

MBA continues to be at the forefront of efforts to help lenders detect, investigate and prevent mortgage fraud. At this year's National Fraud Issues Conference, MBA and the FBI introduced a new Mortgage Fraud Warning Notice. This notice makes clear that mortgage fraud is a serious federal offense with significant consequences for those who commit it. Use of the Notice is voluntary, but MBA strongly encourages lenders to integrate it into any aspect of the lending process that could be susceptible to fraudulent activity.

While collaborative efforts such as this demonstrate that the mortgage industry is willing to come together to combat the crime of mortgage fraud against lenders, the recent growth in incidents also demonstrates that more must be done.

In order to increase resources in the fight, MBA has submitted written requests to the House and Senate Appropriations Committees advocating for \$31.25 million over a five year period in dedicated funding for the FBI and the Department of Justice to combat mortgage fraud. We believe this funding could provide 30 new FBI field investigators, two new prosecutors at the Department of Justice to coordinate prosecution of mortgage fraud cases and \$750,000 to support the operations of Interagency Task Forces in targeted areas with higher than average concentrations of mortgage fraud.

MBA has also reached out to legislators, on both the federal and state level, who have either already introduced or are planning to introduce mortgage fraud bills. MBA will continue to advocate that any anti-mortgage fraud legislation should provide law enforcement officials with all the tools necessary to investigate and prosecute those who commit mortgage fraud.

Though the past year has presented a number of challenges in battling mortgage fraud, it has also brought about a very promising increase in the level of cooperation not only among lenders but between the real estate finance industry and law enforcement. I fully believe that as MBA continues these efforts, the industry will significantly enhance its ability to not only identify and catch fraudsters, but to prevent lenders from becoming victims in the first place.

We will continue to keep you apprised of our efforts in the fight against mortgage fraud.

Most sincerely,

A handwritten signature in black ink, reading "Jonathan L. Kempner". The signature is written in a cursive, flowing style.

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**NINTH PERIODIC  
MORTGAGE FRAUD  
CASE REPORT  
TO  
MORTGAGE BANKERS ASSOCIATION**

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**Mortgage Asset Research Institute, LLC  
A ChoicePoint® Service**

**April 2007**

## **NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO MORTGAGE BANKERS ASSOCIATION**

### Executive Summary

Mortgage origination volume, though at its lowest since 2001, continued to be strong in 2006. The industry began 2007 with an unusually high level of uncertainty, due in equal parts to the relatively high delinquency rates of recent originations and the dramatic dislocations in the subprime segment over the past several months.

This is the ninth annual report by the Mortgage Asset Research Institute (MARI), a ChoicePoint Service, to MBA members. These annual reports examine the current composition of residential mortgage fraud and misrepresentation in the United States. (See Appendix I at the end of this report for information about MARI and the methods it uses to collect data on mortgage fraud.)

The highlights of this report are as follows:

- The number of reports in MARI's Mortgage Data Industry Exchange (MIDEX<sup>®</sup>) database pertaining to 2006 originations is approximately 30 percent higher than the number of reports in the 2005 book of business at the same time last year. Additionally, incidents of mortgage fraud are now more evenly distributed across nearly all states, whereas in prior years, reports tended to be concentrated in relatively few states.
- As this report was being finalized, a significant surge in additional 2006 fraud reports were received which impacted the state rankings.
- There are changes in the rankings of the states in terms of their mortgage fraud experience, with Florida taking over the top spot and Georgia showing the greatest improvement from prior years' rankings.
- California's reported fraud had been quite low in the past few years, and some industry experts have suggested that its problems were masked by high real estate appreciation. The recent slowdown in its housing market may explain California's return to high ranking in this year's report.
- The fraud reports from subprime lenders are consistent in issue and location to the overall reporting results.
- The most common types of fraud found to date in 2006 originations are in the areas of employment history and claimed income.
- The early payment default data for prime loans from First American LoanPerformance is highly influenced by tragic weather events on the Gulf Coast, and few valid conclusions can be drawn from the most recent results. However, this is not the case for subprime loans.
- The current unsettled state of the subprime segment of the industry does not bode well for fraud in the coming year.

The body of this report presents the data and reasoning behind the conclusions cited above.

Organizational Response to Mortgage Fraud

Interest in fraud by the mortgage industry, state regulators and the media continues to be very high in early 2007.

The Mortgage Bankers Association continues to give anti-fraud initiatives high priority, including lobbying Congress for dedicated FBI funding to track and prosecute mortgage fraud, and its recent agreement<sup>1</sup> to promote and foster lender usage of the FBI’s Mortgage Fraud Warning Notice. The notice is intended to educate consumers and mortgage professionals about the penalties and consequences for perpetrating mortgage fraud.

The Financial Crimes Enforcement Network of the Department of the Treasury (FinCEN) is the agency that collects Suspicious Activity Reports (SARs) from all federally-insured financial institutions. Table 1 below shows the significant increase in mortgage fraud SAR submissions to FinCEN over the past several years.

**Table 1**

<b>Mortgage Fraud SARs<sup>ii</sup></b>	
<b>Fiscal Year</b>	<b>SAR Submissions</b>
2006	28,372 (est.)
2005	25,989
2004	18,391
2003	9,539
2002	5,387
2001	4,696
2000	3,515

Last year’s MARI Case Report to the MBA explained how these year-over-year increases in SAR submissions are not entirely reflective of fraud activity. It must be noted that SAR submissions are currently only required of federally-insured financial institutions and their affiliates. Therefore, the fraud experiences of independent mortgage banking companies are not reflected in Table 1. FinCEN estimates that the number of 2006 reports will be about 10 percent higher than the 2005 reports.

Data and Information Sources Used in this Case Report

For more than a decade, major mortgage lenders, agencies and insurers have been submitting information describing incidents of alleged fraud and material misrepresentation to a central database, known as MIDEX, in order to share their experiences within the mortgage industry. Subscribers use MIDEX to help combat mortgage fraud by performing background checks on mortgage professionals or companies as part of their business relationship credentialing process. MARI utilizes this database to obtain statistics on a wide range of

mortgage fraud characteristics. Findings from MARI's research are presented in this Case Report on a periodic basis, as requested by the MBA, as a means of highlighting mortgage fraud trends.

In addition to MIDEX data, this report utilizes data from First American LoanPerformance<sup>iii</sup>, a subsidiary of First AmericanCoreLogic, Inc. First American LoanPerformance tracks the delinquency and prepayment performance of more than 50 million active individual mortgage payments per month. For the past several years, First American LoanPerformance has graciously provided MARI with information about serious early payment defaults for use in our annual Case Report to the MBA. Early payment defaults have historically closely tracked fraud trends reported to MARI and often preceded them by a year or more. Therefore, this report provides the latest available information about where early payment problems are occurring.

#### Increased Reporting of Fraud Cases 2005 to 2006

The number of reports in the MIDEX database pertaining to 2006 originations are almost 30 percent above the number of reports in the 2005 book of business at this time last year. This increase is partially a result of lenders finding and reporting more cases of fraud from their 2006 loan originations. The cooling of real estate markets this past year has also helped reveal cases which strong price appreciation has masked during the past few years.

#### Geographical Distribution of Mortgage Fraud

Table 2 on the next page was developed from fraud cases submitted to MARI by MIDEX subscribers. The first three columns of the table show the rankings of states with the most serious mortgage fraud problems in loans originated<sup>iv</sup> during 2006. The remaining columns of the table show the rankings and a numerical measure of the same 10 states in the years from 2005 back to 2002.

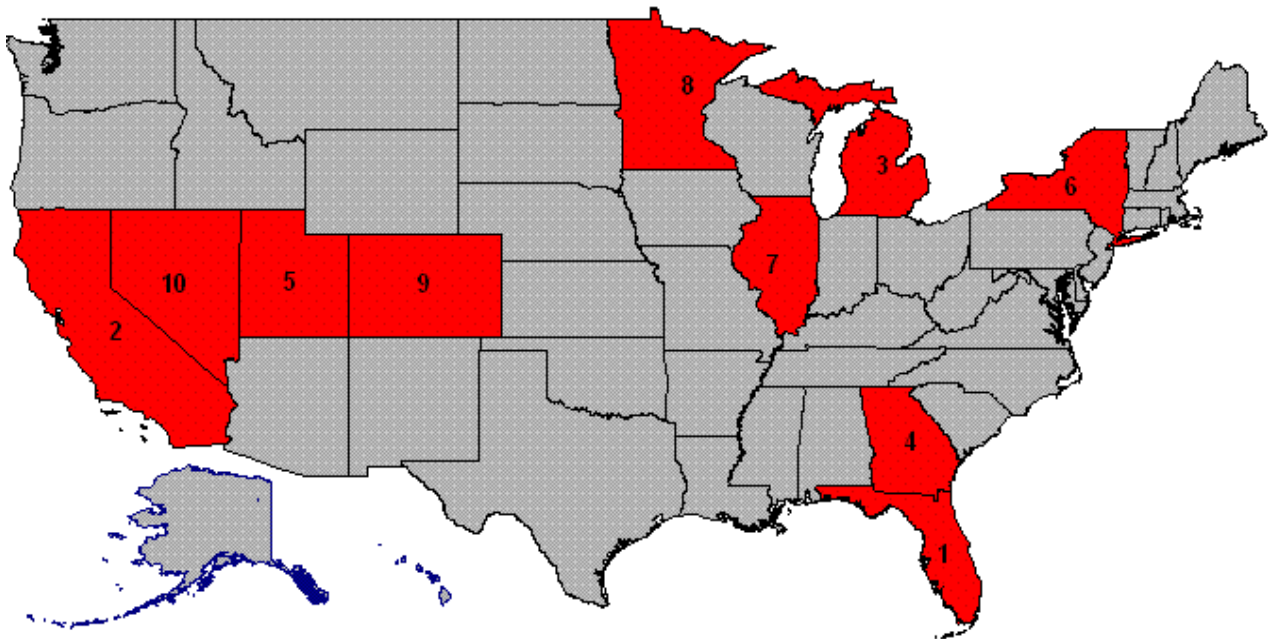
The numerical measure of each state's fraud problem is represented by the MARI Fraud Index (MFI). An MFI of 0 would indicate no reported fraud from a state. An MFI of 100 would indicate that the reported fraud for a state is exactly what one would expect in terms of fraud rates, given the level of loan originations in that state. That is, a state that has 5% of the cases in MIDEX for 2006 and also has 5% of the country's loan originations in the same year would have an MFI of 100. Appendix II at the end of this report explains in detail how the MFI is calculated.

The first row of numbers in Table 2 should be read as follows. Based on fraud reports submitted to MARI through the first quarter of 2007, Florida ranked first in the nation for loans with misrepresentation originated in 2006. The reported fraud rate was more than twice ( $MFI_{FL/2006} = 208$ ) what we would expect, based solely on its origination volume. For loans originated in 2005, Florida had a reported fraud rate 68 percent higher than what it should have had ( $MFI_{FL/2005} = 168$ ) and ranked fourth--or just over half the reported fraud rate of Georgia ( $MFI_{GA/2005} = 310$ ), the highest ranked state that year.

It should be noted that the 2002 through 2005 MFI values for all states listed in Table 2 differ somewhat from those shown in the same table of last year’s Case Report to the MBA. This is due to the fact that Table 2 is based on an additional year of submissions, some of which were reported on loans originated in the 2002 through 2005 period.

**Table 2**

<b>MARI Fraud Index (MFI)<sup>y</sup> By State (2002-2006 All Originations)</b>										
<b>State</b>	<b>2006</b>		<b>2005</b>		<b>2004</b>		<b>2003</b>		<b>2002</b>	
	<b>Rank</b>	<b>MFI</b>	<b>Rank</b>	<b>MFI</b>	<b>Rank</b>	<b>MFI</b>	<b>Rank</b>	<b>MFI</b>	<b>Rank</b>	<b>MFI</b>
Florida	1	208	4	168	5	179	7	164	12	135
California	2	188	8	119	19	68	23	57	30	48
Michigan	3	138	2	196	4	200	6	164	13	130
Georgia	4	125	1	310	1	424	1	506	1	420
Utah	5	122	7	130	6	171	3	175	7	199
New York	6	114	11	107	13	103	14	112	15	115
Illinois	7	113	3	169	7	134	10	133	14	117
Minnesota	8	112	10	115	18	69	26	49	45	13
Colorado	9	108	5	154	3	205	8	162	18	89
Nevada	10	103	14	88	39	26	13	116	27	53



**Figure 1 (Top Ten States Overall for 2006)**

The MFI numbers in Table 2 show how states rank against one another for reported fraud taking place *within the same year*. But these numbers do not compare the rates of reported fraud from one year to the next. For example, if mortgage fraud were an automobile race, the 2006 MFI figures show Florida, California and Michigan as leading the race in 2006. Other states trailed behind them.

As previously noted, reports to the MIDEX database on the 2006 book of business are running almost 30 percent ahead of the reports to the database relative to last year. In our racing example, that means the cars in the 2006 race are running about 30 percent faster than those in the previous year. Table 3 below gives the percentage change in the number of reported fraud cases between the 2005 and 2006 books of business for selected states. The states used are those with the top ten MFI scores to date for 2006 plus Arizona and New Jersey, two states with rather large year-over-year increases.

Table 3 should be read as follows. The number of Florida cases reported to MIDEX through the first quarter of this year for 2006 originations is 143 percent of the 2005 cases reported in the same timeframe last year. New Jersey cases, on the other hand, were running at 250 percent of their rate one year earlier.

Perhaps the most interesting observation from Table 3 is Georgia’s relative decline. This means that Georgia’s reported fraud cases dropped significantly through the first quarter of this year compared to the same quarter last year. A later section of this report deals with some of the possible causes of that state’s drop in fraud.

**Table 3**

State	1 <sup>st</sup> Quarter 2006 v. 2005
Florida	143%
California	214%
Michigan	90%
Georgia	68%
Utah	100%
New York	187%
Illinois	81%
Minnesota	126%
Colorado	78%
Nevada	148%
Arizona	213%
New Jersey	250%

We can draw a number of interesting conclusions from Tables 2 and 3 and from the map.

- The highest MFI value for the 2006 loans to date is Florida at only 208. In prior years, the leading state, Georgia, had MFI values ranging from 310 to 506. Similarly, the ninth and tenth ranked states, Colorado and Nevada, have MFI values only slightly above 100, the expected or “average” MFI value. These results suggest that the 2006 fraud reports received to date are more uniformly spread among the states than has been the case in the past.
- Georgia, the undisputed leader in fraud rates from 2002 through 2005, has dropped to the fourth position for fraud reported to date on its 2006 book of business. For 2006 it is still above the national average ( $MFI_{GA/2006} = 125$ ). There are, however, two factors that are more important than its fourth place ranking. The first is that its MFI figure is only 125, which means that its reported fraud rate is 25 percent above its loan origination rate. In prior years the states ranking fourth had much higher MFI values, due to the condition noted above---mortgage fraud reported for the 2006 book of business is more uniformly distributed than in prior years. The second factor is shown in Table 3, where we see that the actual number of fraud reports on Georgia’s 2006 loans has fallen by 32% from the prior year. This drop may be due to the aggressive legislation, consumer awareness campaigns and enforcement Georgia and federal officials put in place during 2005.
- Despite having top 10 MFI values, Colorado, Illinois and Michigan also reported lower numbers of fraud cases for their 2006 books of business.
- Indiana does not appear among this year’s list of top ten MFI states. It actually ranks twenty-second among the states, which is in sharp contrast to its second place ranking in both 2003 and 2004.

### Prime v. Subprime Fraud Levels

Over the past three years, MARI has delivered annual mortgage fraud case reports to the National Home Equity Mortgage Association (NHEMA) and its members. These annual reports were specific to mortgage fraud trends in subprime originations. As of October 1, 2006, NHEMA merged with the MBA. Therefore, the subprime information presented in this report is expanded compared to past MBA reports.

Subprime lending had grown rapidly in recent years. In late 2006, losses related to loan defaults and fraud greatly diminished investor funding, and subprime originations have fallen sharply. Credit standards have tightened and sources of investor funding have become scarce. Regardless of which investors fill the funding void and when, this segment of originations will continue to have an impact on mortgage fraud trends over the next few years. It will likely take three to five years to uncover most of the fraud and misrepresentation in the 2006 book of business, and MARI will continue to receive MIDEX reports on 2006 loans. During this period of time, many ARM loans will be refinanced, potentially preventing discovery of some of these issues. In spite of these variables, it is still appropriate to look at the geographic distribution of fraud found in subprime loans to determine if it follows the same pattern found in loans taken as a whole.

Table 4 shows the subprime MARI Fraud Indices of the top 10 states over the past five years. Just as in Table 2, the states are ranked by their 2006 MFI values. Those states’ MFI

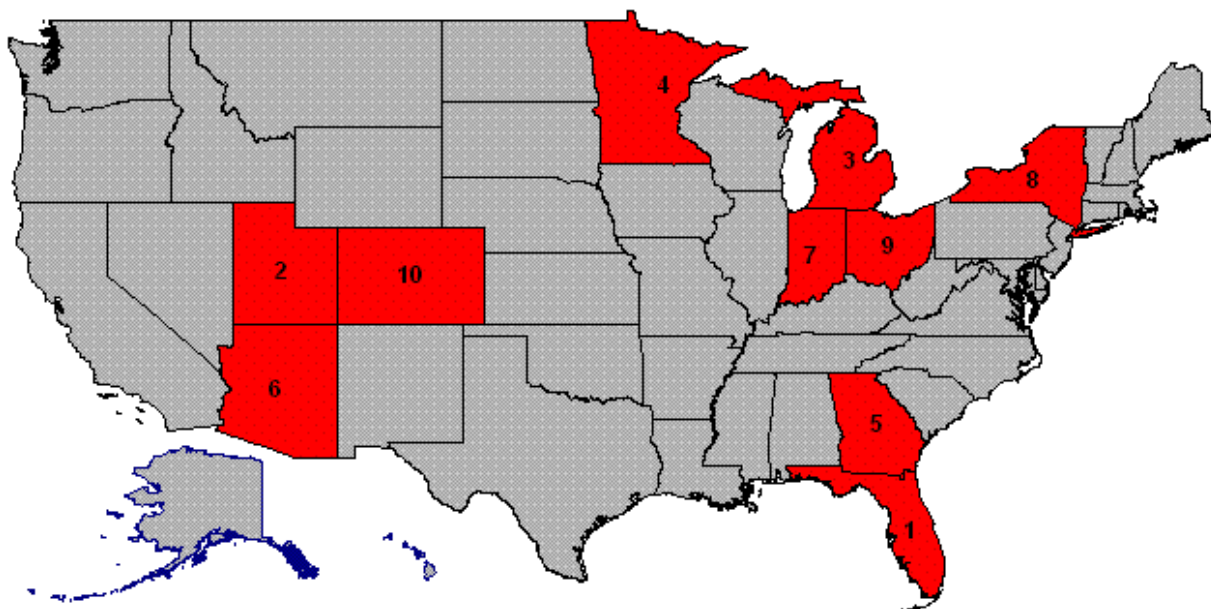
ranks and values for 2002 through 2005 are also listed. Unlike the increased overall number of MIDEX report submissions from last year, reporting specific to 2006 subprime originations is lower than it was at the same time last year for the 2005 book of subprime business. Perhaps the decreased reporting is reflective of the broader challenges these lenders have been facing. Consequently, the values in this report for subprime loans are not as conclusive as in past years.

Table 4

MARI Fraud Index (MFI) By State (2002-2006 Subprime Originations)										
State	2006		2005		2004		2003		2002	
	Rank	MFI	Rank	MFI	Rank	MFI	Rank	MFI	Rank	MFI
Florida	1	241	4	195	2	241	2	227	3	167
Utah	2	209	3	202	5	158	4	167	9	131
Michigan	3	190	2	205	3	204	3	190	6	147
Minnesota	4	162	9	119	21	68	n/a	n/a	n/a	n/a
Georgia	5	152	1	330	1	450	1	719	1	545
Arizona	6	135	19	59	15	84	17	70	19	81
Indiana	7	133	12	100	14	92	8	134	4	159
New York	8	127	11	109	8	108	10	106	7	145
Ohio	9	125	10	113	22	66	11	101	10	127
Colorado	10	120	7	176	4	173	6	140	18	86

The map showing the rankings of states by their subprime MFI values is shown in Figure 2 on the following page. A table similar to Table 3 showing the increases and decreases in reports by state is not provided for subprime lending, due to the reduced numbers of subprime reports. Virtually every state saw decreased numbers of reports. As mentioned earlier, this reduction is more likely due to disruptions occurring in the subprime market rather than a reduction of fraud.

The 2002 and 2003 entries for Minnesota are missing in the table above because the numbers of Minnesota fraud cases reported to MIDEX in those years were too small to be used in the national figures. States that have very low numbers of fraud reported are typically removed from the annual analysis. States thus eliminated from the 2006 subprime analyses to date include Alaska, Arkansas, Delaware, Hawaii, Idaho, Mississippi, New Mexico, Rhode Island and Wyoming. As time passes and more cases are reported from those states, they will be included.



**Figure 2 (Top Ten States Subprime for 2006)**

The preliminary values in Table 4 warrant a couple of observations.

- The states with the highest subprime MFIs this year are similar to those for all loans.
- Georgia, which led the country in subprime rankings as well for the past four years, has dropped to fifth place this year. Georgia's 2006 subprime MFI ( $MFI_{GA/2006} = 152$ ) is well below the 330 value for 2005 loans. It appears that the cooperative efforts of industry members, regulators, legislators and prosecutors are working. (See the following section of this report for a discussion of those efforts.)

### Georgia's Turnaround

After leading the nation for the past four years in overall mortgage fraud and subprime incidents, Georgia has dropped in the top 10 states for 2006 fraud reported to date. Its 2006 MFI values are far below its previous stratospheric levels for all loans and for subprime, in particular.

This dramatic development appears to be due, in large part, to the strong, coordinated stance against mortgage fraud that has been taken by a number of different groups in Georgia—industry members, mortgage and banking regulators, legislators and state law enforcement officials, coupled with the FBI and the United States Department of Justice.

The push began with the premise that victims of mortgage fraud are not just large, faceless financial institutions. The victims include damaged neighborhoods and communities where fraud-related delinquencies and foreclosures contribute to the deterioration of residential

properties, resulting in lower home values and distorted tax assessments. Many members of these groups became concerned about the impact that extensive fraud activity was having on the quality of life and real estate in two of the state's neighboring counties near Atlanta. Some of the affected neighborhoods became homes for squatters, drug traffickers, prostitutes and car theft rings.

In March of 2001, a loose confederation of parties interested in addressing mortgage fraud met for the first time. They called themselves the Georgia Real Estate Fraud Prevention and Awareness Coalition (GREFPAC) and characterized themselves as "outraged at the impact [of mortgage fraud] upon their families' and neighbors' quality of life and safety."<sup>vi</sup> GREFPAC deserves significant credit for mobilizing, educating and energizing many of the parties involved in Georgia's attack on fraud.

In late 2003, the Georgia Department of Banking and Finance made mortgage fraud a priority and introduced a new examination program that focused significant resources on anti-fraud efforts. Subsequently, the number of Cease and Desist Orders and license revocation actions rose dramatically.

In May of 2005, the Georgia State Legislature responded to pleas from many quarters and passed the Georgia Residential Mortgage Fraud Act. In doing so, Georgia became the first state to criminalize mortgage fraud and provided severe penalties of up to 10 years in jail for first offenders and 20 years per property for violations involving multiple properties and loans. The legislation became effective immediately upon being signed by the governor and, within days, four people were arrested and charged under the Act.

About the same time, the Department of Banking and Finance took steps to have all its mortgage examiners trained and qualified as Certified Fraud Examiners.

Law enforcement officers set up sting operations in which more than three dozen arrests were made at, or near, the closing table. Additional arrests, indictments and prosecutions followed at both the state and federal levels. They focused on mortgage brokers, bank officers, closing attorneys, paralegals, real estate agents, appraisers and straw borrowers involved with multiple properties. One closing attorney received a 30-year federal sentence, and jail time was handed down for others involved with her—paralegals, mortgage brokers, real estate agents, appraisers and a money launderer.

There continues to be dialogue, interaction, education efforts and cooperation among members of the industry, their regulators, representatives of victimized neighborhoods and law enforcement. Training has been conducted by the FBI, the Georgia Department of Banking and Finance, and the offices of the U.S. Attorney and the Georgia Attorney General. Cooperative investigations have involved local police, the Georgia Bureau of Investigation, the FBI, HUD, IRS, U.S. Secret Service, FDIC, the VA and the U.S. Postal Inspection Service.

It is possible that future reports to the MIDEX database will raise Georgia's 2006 MFI standing, but the significant drop in Georgia's current MFI ranking suggests that these cooperative efforts are causing fraudsters to think twice, or perhaps move on.

#### National Efforts to Attack Mortgage Fraud

The increased number of fraud reports sent to MARI and Georgia's apparent progress in attacking mortgage fraud with aggressive investigation and prosecution suggest that other groups should follow Georgia's lead. Other states have become active in drafting legislation modeled somewhat after Georgia's Residential Mortgage Fraud Act of 2005. They include New Jersey, Oklahoma, Florida, Nevada and Colorado.

In addition, Mortgage Bankers Association and its membership are urging Congress to provide funding for fraud fighting activities at the FBI and the Department of Justice. The funds sought would be used to support 30 FBI field investigators and two new prosecutors dedicated to addressing mortgage fraud at the national level. The combined efforts of the entire industry, national law enforcement and prosecutors appear to be a good formula for addressing a problem with national scope.

#### Types of Fraud Reported

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 5 for loans originated in the five-year period from 2002 through 2006. The numbers on 2006 loans are very preliminary since fraud perpetrated in 2006 will continue to surface for another two years or more.

Table 5 shows each type of fraud as a percentage of all fraud cases submitted to the MIDEX database. For instance, 55 percent of overall fraud incidents reported to the database for mortgages originated in 2006 contained application fraud, while the subprime equivalent is significantly higher at 65 percent. These percentages are hardly surprising given that the application form is comprehensive in collecting personal identity, employment, asset and liability information.

Table 5

Mortgage Fraud Types					
Fraud Classification	Mortgage Origination Year (Overall / Subprime)				
	2006	2005	2004	2003	2002
Applications	55% / 65%	64% / 66%	64% / 67%	63% / 62%	59% / 56%
Tax/Financial Statements	27% / 16%	21% / 20%	25% / 28%	20% / 24%	17% / 25%
Verifications of Deposit	22% / 14%	18% / 15%	16% / 15%	17% / 16%	15% / 11%
Appraisals/Valuations	11% / 14%	20% / 16%	21% / 14%	29% / 21%	43% / 32%
Verifications of Employment	9% / 10%	11% / 8%	13% / 9%	14% / 8%	12% / 11%
Escrow/Closing Documents	8% / 10%	10% / 7%	10% / 9%	15% / 10%	19% / 11%
Credit Reports	9% / 9%	8% / 4%	8% / 6%	7% / 7%	5% / 7%

It should be noted that the total percentage for each year (the sum of each column in Table 5) exceeds 100 percent. That is because most incidents involve more than one type of fraud.

Many of the percentage figures shown in the table above are similar to those MARI has reported for several years.

#### Appraisal Fraud

Even casual observation of Table 5 indicates that the amount of appraisal fraud reported is significantly lower than one might expect in each of the years, especially in 2005 and 2006. The low levels of reporting are typically due to the fact that reported incidents involve more than one type of fraud. If a reporting lender finds misrepresentation in, for example, the verification of employment and occupancy status, that lender is not likely to pay for the review appraisal to verify appraisal fraud, even if the appraisal appears to be inflated. But these numbers are likely to increase as the lengthy process of reappraisal and value-verification is completed in many investigations. The slowdown in real estate appreciation should also accelerate how quickly appraisal/valuation fraud reports are submitted compared to prior years' reporting trends.

#### Early Payment Defaults (EPDs) Indicate Possible Fraud

This report provides the latest available information about where early payment default problems are occurring. While there are a number of different definitions of an early payment default within the industry, the tables below are based on loans that became 90 days

delinquent within the first three months of origination. Early payment defaults have closely tracked MARI’s fraud reports in the past and often led them by a year or more. However, servicers have relayed reports of fraud schemes specifically designed to avoid early payment default detection. Therefore the predictiveness of EPD data is not as clear going forward.

Table 6 lists the 15 Metropolitan Statistical Areas (MSAs) with the highest early payment default index values based upon 2006 prime loan originations. The EPD index values are derived by dividing an MSA’s early payment default rate by the national rate. As a result, an EPD index value of 0 would indicate no early payment default activity within an MSA. An EPD index value of 100 would indicate that the early payment default rate for an MSA is consistent with national experience, while an EPD of 150 means an MSA’s early payment default rate was 50 percent higher than the national average.

The seven highlighted MSAs in Table 6 reflect areas affected by Hurricanes Katrina and Rita. However, since lender and servicer experience in the hurricane-affected region has shown that these areas are potential breeding grounds for mortgage fraud activity, the highlighted MSAs are left in the list for informational and comparative purposes.

**Table 6**

<b>First American LoanPerformance Data on <u>Prime</u> Loans Early Payment Defaults</b>		
<b>Rank</b>	<b>MSA</b>	<b>2006</b>
1	Hattiesburg, MS	1481
2	Jackson, MS	950
3	Beaumont-Port Arthur, TX	838
4	Biloxi-Gulfport-Pascagoula, MS	600
5	New Orleans, LA	491
6	Mobile, AL	416
7	Buffalo-Niagara Falls, NY	413
8	Enid, OK	406
9	Alexandria, LA	388
10	Corpus Christi, TX	378
11	Danville, VA	313
12	Elkhart-Goshen, IN	303
13	Flint, MI	300
14	Lake Charles, LA	281
15	Jackson, MI	275

Source: First American LoanPerformance

Table 7 shows the First American LoanPerformance EPD scores for the top 10 MSAs with EPD scores above 150 based upon 2006 subprime loan originations.

**Table 7**

<b>First American LoanPerformance Data on <u>Subprime</u> Loans Early Payment Defaults</b>		
<b>Rank</b>	<b>MSA</b>	<b>2006</b>
1	Jackson, MI	337
2	Enid, OK	224
3	Kankakee, IL	212
4	Oakland, CA	211
5	Detroit, MI	203
6	Jackson, MS	196
7	Fitchburg-Leominster, MA	187
8	Stockton-Lodi, CA	176
9	Brockton, MA	175
10	New Bedford, MA	165

Source: First American LoanPerformance

Unlike the prime listing of MSAs with the highest EPD experience, Table 7 shows very little hurricane influence. Specific to subprime loans, Table 7 shows that some midwestern MSAs, California and Massachusetts are experiencing early payment problems among subprime loans. It may be that the California and Massachusetts MSAs made this list, at least in part, due to the slowdown of property appreciation in those states.

### Future Problems

There are currently a number of issues facing the mortgage market. Each of them will have an impact on future mortgage fraud. The following two sections of this report provide some analysis of what those impacts might be.

#### Impact of Subprime Problems on Future Mortgage Fraud

The subprime lending market is currently in disarray. Approximately 50 of its lenders either closed their doors or declared bankruptcy in the first quarter of 2007. While there has been much attention focused on the dramatic events occurring in the subprime market, their implications on mortgage fraud have not been adequately discussed.

The relative contributions to lender failures that have been made by fraudulent activity versus mortgage products that produced unintended results are not known and may never be

clear. However, the future impacts of current industry dislocations on mortgage fraud are less difficult to predict. They are likely to include a confluence of several conditions that could be a recipe for mortgage fraud disaster.

First, a slowdown in the housing market is reducing loan volume. In addition, lenders, investors and regulators in today's subprime lending environment are raising the quality threshold. A clear example of this affects adjustable rate mortgages (ARMs). Many of the teaser rate ARM loans originated in the recent past were underwritten at low start or discounted rates. Federal regulators issued their final "Guidance" standards for alternative instruments on October 10, 2006<sup>vii</sup>. Now regulators and investors are requiring that ARM borrowers be qualified at more realistic rates to demonstrate their ability to accept future payment adjustments. New requirements, combined with more stringent credit policy changes, will take many subprime borrowers out of the mortgage market, further reducing loan volumes.

The subprime lenders who have suspended their origination efforts or shut their doors in the first quarter of 2007 are a veritable "Who's Who" of the industry. A consistent theme in their announcements is that hundreds (if not thousands) of employees are being laid off. Some of these displaced workers will leave the industry, but others will try their hands at various functions in the mortgage origination field--becoming brokers, processors, appraisers and closers.

The bottom line is that there will be more professionals chasing a smaller pool of business. There will be severe pressure on all players to generate volumes that produce revenue and get loans approved for borrowers with marginal credit who had ready access to mortgage money only a few months ago. While most of the professionals in the industry are honest and competent, there will be many that yield to temptation and try to make unqualified borrowers look more qualified than they are. When these conditions are coupled with a regulatory environment (in most states) where fraud perpetrators face relatively light penalties, the conditions are temptingly ripe for escalated mortgage fraud activity. Professional fraudsters will devise new and improved schemes to exploit the weaknesses in loan origination processes.

Future case reports in this series will assess the level of creativity being used to exploit today's changing lending environment.

#### Further Impacts of Real Estate Booms and Slowdowns

In many areas of the country, especially on the East and West Coasts, the dramatic increase in value of residential real estate has lasted for a number of years. Unfortunately, some members of the industry and many consumers have little memory or experience with down markets.

MARI's 2005 Case Report to the MBA discussed the impact of spotty real estate inflation and how lenders and law enforcement reported that fraud was being masked by unusually high property appreciation, especially in California. Therefore, California's low MFI scores in the

recent past may have been somewhat deceptive. Other states' MFI scores may have also been impacted.

Over the past year, some members of the lending community have heard reports that originators and other lending professionals had been dealing with the spectacular rise in numerous residential real estate markets by taking creative steps to help consumers achieve home ownership before being priced out of the market. At the same time, consumers were taking advantage of new or growing equity in their homes. In many cases, the equity was perceived, rather than real, due to unnatural appreciation.

Another reality is that even though many mortgage origination units and companies have had excellent management for 10 to 15 years, in some cases, those managers have little to no experience in planning or responding to constricting markets, overbuilding and performance of the new mortgage products that were designed to help borrowers get into homes during the housing boom.

### An Ounce of Fraud Prevention

While no truly accurate prediction can be made about the two issues discussed above, lenders should consider the following actions to increase their chances of detecting and preventing fraud:

1. Technology helps speed the process but does not replace human judgment in loan review and underwriting.
2. Fraudsters are also taking advantage of technology. A large number of Web sites have popped up on the Internet that enable unscrupulous individuals to create false names, boost credit scores, rent assets and create false documentation. Mortgage fraud perpetrators often have technology as good as, or better than, lenders. They also have virtually unlimited creativity. Lenders should trust only after verification.
3. Lenders must authenticate and verify documents—including the appraisal, to confirm value and appraiser identity. This requires a change in process, additional steps and time in underwriting, and added expense. One lender that put these changes in place told a senior MARI executive, "How can I afford not to re-verify almost everything?"
4. The old lending principle "Know Your Customer" is truer now than ever before.
5. Lenders should use the MBA/FBI Mortgage Fraud Warning Notice as a proactive means of educating borrowers and company employees about the penalties and consequences of fraud.
6. When mortgage fraud and/or misrepresentation is detected, lenders should report it to regulators, law enforcement and MARI.

### A Final Thought

Recent and ongoing events in this industry have taught us an important lesson. Mortgage fraud is a problem which affects everyone—consumers, neighborhoods, real estate professionals, regulators and lenders alike. Mortgage bankers have a key role to play in fighting fraud by improving loan quality and further enhancing loan origination processes to

detect mortgage fraud. Only by doing this can lenders continue to attract the capital that has traditionally made the industry successful.

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## **Appendix I**

### **Source and Analysis of MARI's Mortgage Fraud Data**

The statistical data presented in Tables 2 through 5 of this report were derived from information in a cooperative mortgage fraud database operated by the Mortgage Asset Research Institute, Inc. (MARI). MARI has designed and offered various mortgage industry databases for the past 17 years. Its most recognized database system is the Mortgage Industry Data Exchange (MIDEX<sup>®</sup>) that contains information about licensing, public sanctions and incidents of alleged fraud reported to MARI by MIDEX subscribers.

The MIDEX statistical data discussed in this document were derived from the incidents that MIDEX subscribers describe in reports to MARI. (Agreeing to submit reports describing their fraud investigation findings to the non-public section of MARI's MIDEX system is required for those who wish to access other subscribers' non-public reports.) Only "material misrepresentations" are included in these reports. That is, companies only submit reports to MIDEX in those cases where, knowing what they know after their thorough investigations, they would not have originated, bought or insured the loans in question.

The reports submitted to MARI include the following information about each incident:

- Location of the collateral (state, city and address, to the extent known)
- Names of the originating entity and the loan officer who took the application
- Date the misrepresentation took place
- The method used to verify the existence of the reported misrepresentation(s)
- A short narrative description of the misrepresentation(s) found during the MIDEX subscriber's investigation
- Names of any other professionals that appear to be in a position to influence the accuracy of the information found to be misrepresented, e.g. the name of the appraiser and appraisal firm in cases where the property value is found to be significantly inflated
- A certification from an authorized individual at the submitting mortgage entity that the report is, to the best of his/her knowledge, complete and accurate

MARI staff reviews the reports to assure they meet submission standards for severity and consistency. Submissions are input directly by MIDEX subscribers via an online form, or data entry staffers convert hard copy submissions to a standard, searchable format for inclusion in the MIDEX system. After reading the report's narrative description, a MARI staffer will classify the incident as involving one or more of the types of misrepresentations listed in Table 5.

If MARI makes any changes to a submitted report, it is returned to the submitting subscriber for review prior to its being entered into the system.

The subscribers participating in the MIDEX system represent a wide range of mortgage entities. They include secondary market agencies, all of the major private mortgage insurance companies, and lenders that account for the vast majority of wholesale lending in the country. To access a MIDEX Client List, go to [www.MARI-Inc.com](http://www.MARI-Inc.com) and click on “About MARI.”

## **Appendix II**

### **Computation of the MARI Fraud Index (MFI)**

The MARI Fraud Index, or MFI, is an indication of the amount of mortgage fraud found through MIDEX subscriber fraud investigations in various geographical areas within any particular year. It involves very straightforward calculations.

To come up with Table 2's 2006 MFI for loans in the leading state, Florida, MARI staff determines the percentage of all U.S. MIDEX fraud reports that were submitted for Florida-originated loans in 2006. They determined that, to date, nearly 18.0 percent of MIDEX reports submitted from across the country by subscribers for 2006 originations involved loans on Florida properties. But according to HMDA data, Florida had approximately 8.66 percent of the nation's total 2005 mortgage originations--the most recent year such data are available.

If mortgage fraud were distributed throughout the country like originations, then we would expect 8.66 percent of mortgage fraud to occur in Florida. But the 18.0 percent fraud figure for Florida in 2006 was more than double its origination figure. Therefore, the 2006 MARI Fraud Index for Florida, as of this report's date, is:

$$MFI_{FL/2006} = (18.0/8.66) \times 100 = 208$$

This is, of course, a dynamic figure. Often, a fraud investigation is not completed until a year or two after the loan was originated. MARI will continue to receive Florida fraud reports for another two to three years from its MIDEX subscribers that find misrepresentation in their 2002-2006 book of business. Therefore, Florida's (and all other states') MFI figures will continue to change somewhat in future MBA/MARI Periodic Reports, especially those containing recent years like 2005 and 2006.

It should be noted that the MFI is based on the number of fraud incidents reported for each state, and not the dollar amounts of those mortgages. Therefore, a fraud on a \$120,000 loan in Des Moines, Iowa, is counted the same as a fraud on a \$720,000 loan in Los Angeles, California. Also, there is currently no distinction made between purchases, refinances or home improvement loans in these figures.

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<sup>i</sup> Per the March 8, 2007, press release, found at

<http://www.mortgagebankers.org/NewsandMedia/PressCenter/50728.htm>.

<sup>ii</sup> Financial Crimes Enforcement Network, Mortgage Loan Fraud: An Industry Assessment based upon Suspicious Activity Report Analysis, November, 2006 (Figure 1), found at

[http://www.fincen.gov/mortgage\\_fraud112006.html](http://www.fincen.gov/mortgage_fraud112006.html).

<sup>iii</sup> Formerly Mortgage Information Corporation, aka MIC.

<sup>iv</sup> The dates used in MARI's Fraud Index are when the fraud occurred, which are typically the loan origination or closing dates. Subscribers to the MIDEX system may not discover that a loan involved fraud for several months, or even one or two years after it was originated. As a result, numbers for recent years are dynamic.

<sup>v</sup> Readers that compare the MFI figures in Table 2 for the same states to those found in previous Reports in this series will find that the rates have changed. This is due to the fact that MIDEX subscribers in 2006 continued to uncover and report fraud findings from 2002 through 2005. Therefore all numbers in this Report are dynamic and will undergo some changes as time passes.

<sup>vi</sup> [http://www.grefpac.org/what\\_is\\_grefpac.html](http://www.grefpac.org/what_is_grefpac.html).

<sup>vii</sup> The details of the interagency Guidance can be found at <http://www.ots.treas.gov/docs/2/25244.pdf>.

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