Journal of Forensic & Investigative Accounting
Vol. 6, Issue 2, July - December, 2014

Mortgage Fraud: Schemes, Red Flags, and Responses

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Mortgage fraud has reached epidemic proportions in the United States. Mortgage fraud is a substantial drain on the U.S. economy as estimated annual losses from mortgage fraud exceed $10 billion during the last four years (ACFE, 2013). Such fraud is an attractive playing field for white-collar criminals due to the many types of mortgage fraud, its complexity, and the lack of effective government regulation and private sector self-policing. When mortgage fraud occurs, one or more parties knowingly make deliberate misstatements, misrepresentations, or omissions during the mortgage lending process.[1]

Mortgage fraud allows perpetrators to reap substantial profits through illicit activity that presents a relatively low risk of getting caught. Mortgage fraudsters include licensed and non-licensed mortgage brokers, lenders, appraisers, underwriters, accountants, lawyers, realtors, developers, investors, builders, financial institution employees, homeowners, and homebuyers. Organized crime groups and terrorists have been linked to mortgage fraud. Mortgage fraudsters utilize their experience in mortgage-related industries to conduct numerous and myriad schemes.

Mortgage fraud schemes often involve falsification of bank statements and deposit verifications, illegal transfers of property, production of fraudulent tax returns

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[1] Mortgage fraud is not a process of selling properties for profit after improvements have been made nor is it the same as predatory lending (Carswell and Bachtel, 2007).

and legal documents, and other fraudulent activities. Victims include individuals from across a demographic range, lending institutions, neighborhoods, and the economy as a whole (due to higher default rates, higher mortgage prices, and decreased availability of mortgage credit).

Given the severe impact of mortgage fraud on the economy and its role in the recent financial crisis, it is incumbent upon the public and private sectors to combat such fraud more effectively. A need exists for bank examiners, internal and external auditors, forensic accountants, financial executives and regulators to understand the inner workings of mortgage fraud schemes and the steps that can be taken by the public and private sectors to achieve detection, deterrence, and prevention.

The purposes of this article are to explain types of mortgage fraud schemes and their red flags or warning signs and offer common sense steps that can be implemented by federal and state regulators and private industry professionals, including forensic accountants and others, to detect, deter and prevent mortgage fraud.

This paper is divided into three sections. First, we provide a detailed overview of various types of mortgage fraud schemes and their warning signs. Second, we discuss the lack of government response to and the negative effects of mortgage fraud on children, neighborhoods, and others. Third, we cover the responses of the public and private sectors to mortgage fraud. In this third step, we also highlight the ways that private industry professionals can assist in the fight against mortgage fraud.

COMMON MORTGAGE FRAUD SCHEMES

While individual types of schemes exist, the FBI categorizes mortgage fraud into two broad categories: "fraud for property" schemes and "fraud for profit" schemes (FBI, 2010a).

Fraud for property is most often committed by home buyers attempting to purchase a personal residence. Typically, fraud for property occurs when a loan applicant materially misrepresents or omits information with the intent to deceive the lender into lending money. Borrowers who misrepresent employment history, income history, and undisclosed debt to get financing are committing fraud for property.

In contrast, fraud-for-profit schemes are used as a way to make money. For these schemes to be successful, the perpetrator needs assistance from someone on the "inside" that knows the industry. These industry insiders are lawyers, bank officers, appraisers, mortgage brokers, real estate agents, settlement agents, and loan originators. The fraudulent activities in these schemes include appraisal fraud, fraudulent flipping, straw buyers, and identity theft (FinCEN, 2006).

Individual Scheme Types

There are many different types of individual mortgage fraud schemes, such as: a) foreclosure rescue, b) home equity conversion, c) loan modification, d) illegal property flipping, e) builder bailout, f) equity skimming, g) straw buyers, and h) short sales. Oftentimes, various combinations of these schemes are implemented in fraudulent transaction(s).

a) Foreclosure Rescue Schemes

Foreclosure rescue schemes involve foreclosure rescue con artists seeking out homeowners who have fallen behind on their mortgage payments and are facing potential foreclosure. The scammer convinces the homeowner that his/her house can be saved from foreclosure with the promises of paying off the delinquent mortgage and helping the homeowner stay in the property. The scammer often solicits the distressed homeowner via a mailing promising short-term financing from an investor who will pay off the delinquent mortgage. Often, the distressed homeowner is told he or she can stay in the residence and make rent payments to the alleged investor. When the homeowner makes rent payments to the scammer, the homeowner is doing so with the belief that he/she will be able to buy back the home after a certain amount of time has passed. The homeowner may also be persuaded to transfer his/her ownership interest in the property as collateral. The scammer promises that the homeowner can continue to live in the home and repurchase it later or promises the homeowner new financing. If the scammer promises new financing, the scammer must use a straw buyer (someone who will qualify for financing). The scammer convinces the straw buyer to apply for a mortgage based on misrepresentations that he/she is purchasing an investment property with an existing tenant (the distressed homeowner).

What happens to the homeowner in these foreclosure rescue schemes? The straw buyer, who now has title to the property, typically defaults on the "new financing" mortgage causing the home to go into foreclosure. Ultimately, many homeowners affected by this scheme are evicted and lose all equity.

An example of a foreclosure rescue scheme involving two Florida residents occurred in 2012. Lisa Wright and Cathy Saffer received prison sentences of 66 and 60 months, respectively, for defrauding mortgage lenders and homeowners (U.S. Department of Justice, 2012). According to trial documents, Wright and Saffer, who operated Foreclosure Solution Specialists (“FSS”), told homeowners who were at risk of foreclosure that FSS could help them stay in their homes. Wright and Saffer misrepresented to victims that their homes would be sold to investors and that after the sale, they could continue living in their home with the opportunity to re-purchase the house at a later date. The defendants arranged for straw buyers, whom were paid to participate in the fraud, to purchase the homes through a sham sale. In addition to the straw buyers, Florida C.P.A. Barrington Coombs, was paid to write a sham letter to verify false information for different loan applications. The defendants were able to pocket the money from the equity in the homes. Not surprisingly, the houses went into foreclosure and the victims lost all equity, while being evicted.

Various red flags or signs often appear in foreclosure rescue schemes. Below is a list of indicators of this fraud scheme:

- The borrower is advised by the foreclosure specialist to avoid contact with the servicer;
- The borrower receives a purchase offer which is greater than the listing price;
- The borrower states that he or she will be renting back from the new owner;
- The borrower executes a quitclaim deed to a third party on the advice of a foreclosure specialist;
- Signature variations exist between the borrower’s signature on the loan origination documents and the short sale contract;
- The borrower has recently updated contact information; and
- The borrower states he or she is sending mortgage payments to a third party (Fannie Mae, 2009).

One red flag by itself does not mean fraud is ongoing or has occurred but two or more red flags should be investigated.

b) Home Equity Conversion Mortgage Schemes

Fraudulent schemes also occur with home equity conversion mortgages ("HECM") involving senior citizen homeowners. An HECM is a reverse mortgage loan product insured by the Federal Housing Authority available to borrowers over the age of 62. In short, these loans allow seniors to convert a portion of the equity in their homes into cash. Repayment of the reverse mortgage is due when the senior ceases to occupy the property as his/her primary residence, sells the home, or upon the death of the senior.

Often with the aid of straw buyers, fraudsters design a scheme to withdraw false equity from property (FBI, 2009). Typically, fraudsters identify distressed, abandoned, or foreclosed properties and purchase the properties using straw buyers. The straw buyers falsely state they will be occupying the property as their primary residence thereby committing occupancy fraud. After the straw buyers' purchase, the fraudsters recruit senior citizens to "purchase" the property from the straw buyers by transferring title to the senior citizen without an exchange of money. After the senior citizen has occupied the residence for 60-days, the fraudsters arrange for the senior citizen to obtain an HECM. The fraudster "helps" the senior citizen qualify for the HECM through the use of an inflated appraisal. The fraudsters also encourage the senior citizen to request a lump sum disbursement of the equity. The fraudsters pay a fee to the senior citizen and pocket the rest of the cash or take the full disbursement unbeknownst to the senior citizen.

In February 2013, a Miami title agent and former mortgage broker was found guilty for her role in a reverse mortgage fraud scheme (U.S. Department of Justice, 2013). Yesenia Pouparina, a licensed title agent in Florida, created a scheme to obtain a reverse mortgage loan on her property in the name of her mother who did not meet the requirements for the HECM program. To support the HECM application, Pouparina submitted a false loan application and altered records to misrepresent her mother's eligibility to participate in the program. Pouparina acted as the title agent for the loan and disbursed the loan proceeds directly to her own personal bank accounts. She further enriched herself by collecting fees generated by closing the loan and using the loan proceeds in other mortgage deals.

A myriad of red flags or signs of fraud often manifest themselves in reverse mortgage fraud. Some of these red flags are as follows:

- The loan file has no notes indicating how the proceeds will be used;
- The loan file notes indicate that the borrower lacks knowledge about the property such as location, size, number of rooms, etc.;
- The distressed property is conveyed to the senior by quitclaim deed just prior to the reverse mortgage loan application;
- The senior's credit report is inconsistent with information on the loan application;
- Communication with the loan officer is done only through a person holding a power of attorney;
- The senior borrower takes loan proceeds in a lump sum at closing;
- Reverse mortgage proceeds are used to remove or pay off a non-borrower lien;
- The senior has no history of home ownership; and
- The loan file indicates that hazard insurance has lapsed or property taxes are delinquent (FFIEC, 2009).

Again, the presence of two or more red flags or fraud signals merits further investigation. One red flag by itself may not indicate mortgage fraud.

c) Loan Modification Schemes

Loan modification schemes are another type of mortgage fraud. Fraudsters use a variety of tactics to get attention of distressed homeowners. For a fee, the scam artist tells the distressed homeowner that he will negotiate a deal with the lender to reduce the mortgage payments or to save the home. The fraudster may claim to be an attorney or represent a law firm. The scam artist will tell the distressed homeowner that he or she should not contact his or her lender, lawyer, or credit counselor. Some fraudsters even insist that the distressed homeowner make mortgage payments directly to them while they negotiate with the lender. These fraudsters collect a few months of payments in addition to some fees. Inevitably, the con artists stop returning the distressed homeowners' calls and disappear with the money. In the end, the homeowners will likely lose their homes.

Gary Bobel, Scott Thomas Spencer, and Travis Iverson were sentenced to prison for stealing over $11 million from more than 4,000 people seeking to modify their mortgages (FBI, 2012). In 2008, defendant Bobel opened a loan modification company in California and hired telemarketers who preyed on homeowners facing foreclosure. Defendants Scott and Iverson and another defendant, Mark Spencer, were telemarketers who falsely (i) promised that they had a network of attorneys who would pre-screen clients, (ii) claimed they had been in business for 20-years, (iii) boasted of a 98 percent success rate in obtaining loan modifications, and (iv) asserted that there was a money-back guarantee. The defendants persuaded many distressed homeowners to pay the company's fees rather than staying current on their mortgage payments. Many victims lost thousands of dollars because of this fraudulent scheme.

This type of scheme has numerous red flags associated with it. Below are some of the more salient ones:

- The borrower states that the property is his or her primary residence but the mailing address and/or phone number in the file are not for the subject property;
- The file contains no employment/income verification;
- The file contains no or a limited financial analysis;
- A loan modification company demands the payment of a large upfront fee (before services are rendered);
- A loan modification firm claims to have obtained modifications for 90 percent of its clients or guarantees that it can stop a foreclosure;
- A loan modification company tells the borrower to stop communicating with his or her lender;
- A loan modification company advises the borrower to stop paying the mortgage and pay the company instead;
- A company pressures borrowers to sign over title to their homes; and
- A firm encourages homeowners to lease their homes so they can buy them back over time (FFIEC, 2009; Fannie Mae, 2009).

Fraud may not be present even though one red flag is occurring. Usually two or more red flags or signs of fraud are required to devote resources to closer scrutiny.

d) Illegal Property Flipping Schemes

Illegal property flipping is another type of mortgage fraud. This fraudulent scheme occurs when property is purchased, appraised at a higher value than it is worth, and then sold immediately for a profit with an artificially inflated value. This scheme can involve one or more of the following: fraudulent appraisals, falsified loan documentation, inflated buyer income, and collusion of and/or kickbacks to buyers, investors, loan brokers, real estate brokers, appraisers, and title company employees (FBI, 2005). Straw buyers, industry insiders, and identity theft often are used to execute fraudulent property flipping schemes. Typically, a real estate agent is not employed, and these are not arms-length transactions.

Geoffrey Montani and Kenneth Jones of Portland, Oregon, were sentenced to 15 months in prison for their convictions in connection with a mortgage fraud scheme (FBI, 2013a). During a two-year period, the defendants bought and resold ("flipped") houses in Portland with money provided by Defendant Montani's father and other investors. In 37 transactions, the defendants knowingly sold houses to straw buyers. The defendants contacted another member of the scheme, Marty Folwick, who would arrange for a straw buyer for the property and then receive a kickback at closing. Based on false promises that the straw buyers would become successful real estate investors, the straw buyers allowed the defendants to use their names and credit scores on mortgage applications. Once the loan (which was supported by false information) was approved, the property was sold to the straw buyer and the defendants would pay off the investors and divide the profits between themselves. In every transaction, the property fell into foreclosure. The losses on the 37 properties identified by the government totaled $1.9 million.

The presence of two or more of red flags merits further investigation. The existence of one red flag does not mean fraud has occurred. As with other schemes, property flipping has many red flags. Here are some of the more prominent ones:

- The property is listed for an extended period of time and sells for higher than list price;
- The property seller is not the owner of record;
- The seller is an entity such as an LLC or corporation;
- The property has been sold or transferred within the last six months;
- The borrower owns an excessive amount of real estate;
- Notes in the loan file suggest the borrower pushed for a quick closing;
- Comparables in the appraisal are unusual; and
- The owner listed on the appraisal/title may not match the seller on the sales contract (FFIEC, 2009).

e) Builder Bailout Schemes

Yet another type of mortgage scheme is builder bailout fraud. In a saturated market of unsold new homes and condominium units, builders feel pressure to pay outstanding construction loans. Sometimes, the pressure to pay the construction loans leads builders to resort to fraudulent methods. One variation of the builder bailout fraud occurs when the builder lures a real estate investor by offering property management services for the potential rental property along with an agreement that the builder will absorb any negative cash flow from the property for a stated timeframe. Once the real estate investor has closed on the property, the builder backs out on his promise to manage the property and obligation to absorb the negative cash flow. Builder bailout fraud also can occur when the builder offers excessive incentives that are undisclosed to the lender. Incentives such as "no money down" or paying the closing costs for the buyer result in the lender financing a high loan-to-value ratio, perhaps exceeding 100 percent. Another variation of this fraud is the use of comparables or "comps" exclusively from the builder's developments which have inflated sales prices.

In March 2013, seven individuals, Aleksandr Kovalev, Arthur Menefee, Florence Francisco, Adil Qayyum, Jannice Riddick, Elsie Fuller and Leona Yeargin, were indicted in a mortgage fraud scheme involving the purchase of at least 23 homes (FBI, 2013b). According to the indictment, Kovalev developed and sold property in Sacramento, California. As the real estate market was declining, Kovalev, Menefee, and Franciso recruited individuals with sufficient credit scores to act as straw buyers for residential properties. Kovalev, through Menefee, Francisco, and Qayyum made cash incentive payments to the recruited straw buyers. These incentive payments were concealed from the lenders. The indictment also states that these fraudsters allegedly prepared fraudulent loan applications for the lenders by falsely stating the straw buyers' incomes, assets, and intent to occupy the properties as their primary residences. In addition, Yeargin and Fuller used the identity of an individual without that individual's knowledge or authorization to purchase property from Kovalev as part of the scheme. If convicted, the defendants Kovalev, Meneff, Qayyum, Riddick, and Francisco face a maximum penalty of 30 years in prison and a $1 million fine. Fuller and Yeargin face a maximum penalty of 20 years in prison and a $250,000 fine and a consecutive two-year sentence for the aggravated identify theft counts.

A forensic accountant may not pursue further investigation with the existence of one red flag but the existence of two or more of the red flags below warrants closer examination. Below are various red flags or signs of fraud:

- The HUD-1 form shows disbursements from the builder's (as seller) funds to persons or entities not reflected as lienholders or vendors on the title commitment;
- All comparable sales in the appraisal are from the same project;
- A reference to secondary financing on the purchase contract but not on the loan application;
- Parties to the transaction appear affiliated based on file documentation;
- Existence of incentives that include prepaid condominium fees, principal and interest payments for a year, buy down, free furniture, automobiles, parking spaces, boat slips, etc.;
- Robust townhouse or condominium sales in a slow market; and
- The credit report shows many loans to one applicant (FFIEC, 2009).

f) Equity Skimming Schemes

Equity skimming schemes occur when mortgage fraud perpetrators drain all of the equity out of a property (FBI, 2010b). One variation of this scheme involves perpetrators charging inflated fees to "help" homeowners profit by refinancing their homes multiple times; however, in reality, the homeowners are skimming all the equity from their property. A perpetrator will also "help" a homeowner establish a home equity line on a property and then encourage the homeowner to access these funds for investment in various scams. Another method leading to equity skimming occurs through the use of an inflated sales contract and inflated appraisal. The perpetrators involved in this type of fraud will raise the sales price to cover the buyer's down payment and/or closing costs or to get cash back at closing. Consequently, the loan amount is higher than the true value of the property, effectively skimming all the equity from the property.

An equity skimming scheme does not have as many red flags associated with it as other mortgage fraud schemes. Below are various red flags that may evince fraud:

- Title to the subject property has recently transferred;
- The purpose for any cash-out is not well-documented;
- The borrower is receiving cash back at closing in a purchase transaction;
- There is a cash-out refinance shortly after the property has been purchased (FFIEC, 2009); and
- A counselor or mortgage firm that says it is necessary for the buyer to temporarily sign over title.

Again, the occurrence of two or more red flags merits close scrutiny of the situation.

g) Straw Buyer Schemes

In this scheme, a real estate agent or broker finds a person with good credit who becomes the "straw" to buy a home for a third person. The latter may be a family member, stranger, friend or a fictitious person who the agent or broker indicates cannot obtain a loan due to lackluster credit. The straw buyer has no intention of living in the subject property or making payments on any loan. The real estate agent or broker may sell the home to the straw at an inflated price to obtain a higher loan amount and pad the commission.

A mortgage broker involved in the scheme may process false documentation to allow the straw to acquire the property. The straw buyer ultimately signs the paperwork. The straw does not pay or makes few payments on the mortgage and the mortgage lender commences foreclosure.

Below are red flags or signs of this mortgage fraud scheme:

- The loan is usually an early payment default;
- The buyer does not really intend to occupy due to an unrealistic commute, size, or condition of the property;
- Inconsistent signatures may be found in the file;
- Title to the property is conveyed after the sale closes;
- Credit history in the file is inconsistent with the borrower's age; and
- Returned mortgage loan payment coupons and/or monthly statements (FFIEC, 2009; Fannie Mae, 2009).

h) Short Sale Schemes

A short sale is one in which the sales proceeds are less than the balance owed on the mortgage loan. The mortgage lender and other lienholders and any mortgage insurer must approve the transaction. Fraud occurs when a borrower withholds mortgage loan payments forcing the loan into default so an accomplice can "submit" a "straw" short sale offer at a purchase price less than the borrower's loan balance. A fraud occurs if the mortgage lender is misled into approving a short sale offer when the price is not reasonable and/or conflicts of interest are not properly disclosed.

Short sale fraud scheme indicators include:

- The occurrence of a sudden default with no workout discussions and an immediate request for a short sale;
- The loan file suggests ambiguous or conflicting reasons for a default;
- A mortgage loan default or delinquency is inconsistent with the borrower's spending, saving, and other credit patterns;
- The seller feigns financial hardship and hides assets (some on the original loan application are dissipated);
- County records show that the property was flipped soon after the short sale at a higher price;

- County records indicate that ownership was transferred back to the seller after the short sale; and
- An unusually high commission is paid to the real estate agent (FFIEC, 2009; Fannie Mae, 2009).

LACK OF GOVERNMENT RESPONSE TO THE MORTGAGE FRAUD CRISIS AND ITS CONSEQUENCES

The responsibility to investigate and prosecute mortgage fraud rests with local, state, and federal law enforcement officials. At the federal level, the FBI investigates and refers cases for prosecution to the Department of Justice. As early as 2004, the FBI suspected fraud in the mortgage and subprime mortgage markets, but did not pursue investigations due to inadequacies of data regarding fraud and a resource shift to anti-terrorism efforts (FCIC, 2011; Ramirez, 2010; Lichtblau et al., 2008). For example, suspicious activity reports (SARs) are reports filed by FDIC-insured banks and their affiliates with the Financial Crimes Enforcement Network (FinCEN). SARs are filed by financial institutions when they suspect criminal activity in a financial transaction. Many mortgage originators were outside FinCEN's jurisdiction and not required to file SARs (FCIC, 2011). Also, evidence exists of underreporting for those financial institutions required to file SARs (FCIC, 2011).

The jump in mortgage fraud drew attention due to a substantial increase in SARs potentially related to mortgage fraud. In 2005, 25,988 SARs related to mortgage fraud were filed (FCIC, 2011). In 2009, the number rose to 67,507 (FCIC, 2011). Federal law enforcement responded to this alleged fraud crisis, but not in a vigorous manner. The response of the federal government contrasts sharply to its reaction to the savings and loan (S&L)/bank real estate crisis in the 1980s. In that crisis, the DOJ formed a series of strike forces based in 27 cities that was staffed with 1,000 agents and forensic experts and dozens of federal prosecutors (Jordan, 2011). Even though the number of agents devoted to mortgage fraud increased from 15 to 177 agents between 2004 and 2010, the overall staffing level remained hundreds of agents below the levels seen during the S&L/bank real estate loan crisis (Ramirez, 2010; Lichtblau et al., 2008). Once more than 500 white-collar crime specialists were transferred to national security cases, the administration refused to allow the FBI to hire new agents to replace the lost white-collar specialists (Black, 2012).

Moreover, unlike the S&L/bank real estate crisis, financial regulatory agencies have provided little assistance to the FBI in the mortgage fraud crisis (FCIC, 2011). Evidence indicates that the lack of assistance did not change after the Obama administration took office (TRAC, 2011). Local law enforcement reaction to the mortgage fraud crisis has been even less than the federal response.

State and local law enforcement have their own concerns about whether they can adequately address the mortgage fraud crisis (Carswell and Bachtel, 2007). Many disincentives exist for conventional police forces to address mortgage fraud. These include such reasons as the amount of time needed to resolve such cases, the apparent mundane nature of the offenses, public pressure to eradicate street crime and the lack of competence to address complex financial crimes (Carswell and Bachtel, 2007). The indifference on the part of local law enforcement is widespread despite evidence that the spillover effects of mortgage fraud include the creation of an environment for a rise in violent crimes and neighborhood deterioration (Immergluck and Smith, 2006). In fact, the depth of victimization is so extensive that its full consequences are not known yet

(Whelan, 2010).

Victims of white-collar crime, such as mortgage fraud, suffer more and experience greater losses and spillover or collateral damage than victims of street crime (Huff et al., 2010). One example is the effect of mortgage fraud on children. Not only does mortgage fraud and deceit affect the parents, but it also has contributed to a growing number of homeless youth (Elboghdady, 2010). School administrators report more and more children who are moving from shelters to park benches and cars because their parents have lost their homes (Hall, 2009).

Mortgage fraud has also increased the destabilization of lower-income neighborhoods (Immergluck and Smith, 2006). The safety issues tied to mortgage fraud are of greater concern given that mortgage fraud has been linked to both terrorism and organized crime (FinCEN, 2006). Criminals with links to Middle Eastern extremist groups have perpetrated mortgage fraud and wired proceeds gained overseas to fund terror activities in such states as Utah, Michigan, Ohio, Virginia, and California (Poole, 2007).

An effective counterattack against the direct damage and spillover effects of mortgage fraud requires the efforts of private interests, community organizations, and public and regulatory officials. Of course, such a counterattack requires the utilization of the skills of forensic accountants. Before-the-fact regulation (or prevention) is more effective than after-the-fact prosecutions. When the two operate together, it is possible to deter mortgage fraud and send a message about swift enforcement (Black, 2012).

RESPONSES OF THE PUBLIC AND PRIVATE SECTORS

The detection and prevention of any future wave of mortgage fraud requires that numerous steps be taken by both the private and public sectors. While some steps should be taken separately by each sector, others should be taken jointly or in a cooperative manner. First, we review what improvements have been or can be made in the public sector.

Improved Regulation and Prosecution of Mortgage Fraud

Regulatory agencies must remain aware of the interplay of the regulatory process and economic cycles. In periods of economic growth, a breakdown in regulatory oversight occurs, often caused by pressure on regulators not to stand in the way of economic prosperity (Black, 2012). Regulatory complacency allows mortgage fraud practices to flourish and go unpunished. When an economic recession commences, mortgage fraud prosecutions increase and a call goes out for better regulation. The worst offenders go to prison and millions of dollars are spent on prosecutions, but the justice system cannot compensate for the damage caused by fraud schemes that should have been prevented by sound regulation during prosperity times (Valukas, 2010). Effective regulation involves numerous steps.

One necessary step that has already been taken by federal regulatory authorities is the reinstatement of tougher requirements for full underwriting of income, assets, liabilities, credit ratings/scores, and appraisals for mortgage lenders.[2] Underwriting compliance must be evidenced in writing and be retained for at least five to ten years from the date of loan closing. Effective and continued use of these standards is a key to avoidance of another mortgage fraud crisis and will facilitate any future mortgage fraud investigations.

A second step that is also underway is improved regulation of mortgage brokers (also called "originators"). Before the sub-prime mortgage crisis, mortgage brokers dominated the loan origination market (Funkhouser, 2010). The Federal Reserve Bank of Minneapolis estimates that two-thirds of mortgage loan transactions in 2006 occurred through third-party mortgage brokers (Backley et al., 2006). Mortgage brokers have been involved in or contributed to mortgage fraud. During the mortgage fraud crisis, it was often the mortgage broker who filled out the loan application and inserted the borrower's income (Murdock, 2010). One study discovered that of 100 stated income loans that were checked against tax documents, 90 percent overstated income by at least five percent. In 60 percent of the cases, stated income exaggerated actual income by more than 50 percent (Reckard, 2008). The Mortgage Asset Research Institute found that 26 loans originated by one mortgage broker contained false Social Security numbers,

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[2] Title XIV of the Dodd-Frank Act (15 U.S.C. §1639(c)) prevents a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan. A determination of ability to repay shall include a consideration of the consumer's credit history, current income, expected future income, debt-to-income ratio, employment status, and other financial resources. Residential mortgage loan creditors must verify amounts of income or assets by reviewing W-2 forms, tax returns, payroll receipts, financial institution records, or other third-party documents. Income verification by lenders includes the use of IRS transcripts of tax returns.

inflated incomes, fabricated bank statements, and forged borrower signatures (Murdock, 2010). During the years 2003-2007, over 500 mortgage brokers licensed in Florida had criminal records that should have been an obstacle to obtaining a mortgage broker license (Barry et al., 2008).

Title XIV of the Dodd-Frank Act (15 U.S.C. §1631) requires all mortgage originators to be properly qualified, registered and licensed in accordance with state or federal law. States are also required to adopt minimum standards for licensing residential mortgage loan originators. If the Bureau of Consumer Financial Protection (established under the Dodd-Frank Act) determines that a state's loan origination licensing system does not meet minimum licensing requirements, then the Bureau must establish and implement a licensing system in that state. As of June, 2013, over 400,000 mortgage loan originators were registered in the National Mortgage Licensing System (NMLS)[3](Conference of State Bank Supervisors, 2013).

In the licensing process under the NMLS, each mortgage loan originator is assigned a unique identifier in the NMLS that must be included on all loan documents. Unique identifiers must be made available to consumers by financial institutions covered by the Dodd-Frank Act. The unique identifier makes it possible to track a mortgage broker across state lines thereby helping officials to prosecute fraud offenders. The identifier may also deter fraud by mortgage brokers.

The purpose of the licensing system is to provide increased accountability, reduce

[3] NMLS is the system of record for non-depository, financial services licensing or registration for participating state and territorial agencies. It is also the sole system of licensure for companies and individuals seeking to apply for, amend, renew, or surrender license authorities. NMLS itself does not grant or deny license authority. It is also the system of record for the registration of depositories, subsidiaries of depositories, and mortgage loan originators.

fraud, provide accessible information to consumers on the history and background of mortgage loan originators, and improve the flow of information among regulators. The purposes of the licensing law are supported by enforcement powers. The Bureau may examine any books, papers, records, or other data of any mortgage loan originator and summon any custodian of such records.

A third step is that federal and state bank examiners should conduct regular audits or reviews of the work product or files of mortgage lenders of all types, including mortgage brokers. The audits or reviews can be two pronged. First, individual mortgage loan files should be audited to determine whether established underwriting guidelines have been followed. Those mortgage lenders that have exceeded an acceptable level of nonconforming loans (i.e., those that do not adhere to standard underwriting criteria) should be subject to further investigation. Second, every significant mortgage lender and/or broker should be scrutinized to determine whether they have surpassed the appropriate number of criminal referrals (such as SARs) that would be expected (Black, 2012). Federal and state financial examiners, if necessary, could be supplemented or assisted by forensic mortgage auditors. A forensic mortgage audit is a comprehensive review of all loan documentation including legal documents, transactional data, and the appraisal. A skilled examiner identifies any illegalities or questionable items related to the lender, broker, appraiser, realtor or other party. Improved regulation can be supported by more effective criminal and civil enforcement actions.

When the threat of prosecution is more certain than in the present environment, mortgage fraud may be deterred. A fourth step is that fines collected by the SEC and DOJ should be used to hire about 1,000 additional white-collar crime specialists as FBI agents to replace those transferred to national security cases. The FBI and DOJ should follow the successful strategy used during the S&L debacle and establish a "Top 100" priority list of the most important criminal mortgage fraud cases from the most recent financial crisis (Black, 2012). Although government resources are limited, it is possible to improve current prosecution strategies.

Although no federal mortgage fraud statute exists, federal law enforcement authorities employ a wide variety of statutes to investigate and prosecute mortgage fraud schemes. These statutes involve bank fraud,[4] wire fraud,[5] mail fraud,[6] false statements,[7] money laundering,[8] conspiracy,[9] equity skimming, if applicable,[10] social security number

[4] 18 U.S.C. §1344 (2010). Bank fraud happens when a person knowingly commits or attempts to commit a scheme to "(1) defraud a financial institution or 2) obtain any of the money, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution by means of false or fraudulent pretenses, reputations, or promises."

[5] 18 U.S.C. §1343 (2010). Wire fraud occurs when a person "having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice."

[6] 18 U.S.C. §1341 (2010). Mail fraud occurs when one "having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses … places in any post office or authorized depository for mail matter, any matter or thing " that is "to be sent or delivered by the Postal Service, or … by any private or commercial interstate carrier."

[7] 18 U.S.C. §1014 (2010). False statements occur when a person "knowingly makes any false statement or report, or willfully overvalues any land, property, or security, for the purpose of influencing in any way" the actions of the Federal Housing Administration, any Federal Reserve Bank, or any institution of which the accounts are insured by the FDIC or Office of Thrift Supervision.

[8] 18 U.S.C. §1957 (2010). Money laundering occurs when one "knowingly engages or attempts to engage in a monetary transaction in criminally derived property of a value greater than $10,000 [that has been] derived from specified unlawful activity."

[9] 18 U.S.C. §371 (2010). Conspiracy occurs when two or more people agree to join forces and carry out some illegal activity. The illegal activity does not have to be accomplished. At least one of the co-conspirators must have carried out one overt act in furtherance of the conspiracy.

[10] 12 U.S.C. §1709-2 (2010). Equity skimming occurs whenever a person, with intent to defraud, purchases a one-to-four family dwelling subject to a loan in default that is secured by a mortgage or deed of trust insured or held by the Secretary of HUD or guaranteed or made by the Department of Veterans Affairs, fails to make payments under the mortgage or deed of trust, regardless of whether the purchaser is obligated on the loan, and applies or authorizes the application of rents from such dwellings for his or her own use.

fraud,[11] and false identification fraud.[12] Prosecutors do not have an easy task in choosing among the various charging statutes and they must understand the transactions that occurred to apportion blame and prove intent to defraud among several perpetrators (Ceresney et al., 2009). Mortgage fraud cases are complex and involve a specialized area of the law in which law enforcement needs more training (Hutchins, 2011).

A fifth step and clean fix for this situation is an actual mortgage fraud statute. Given the difficulty in passing new laws (and criminal laws cannot be passed and applied ex post facto), the focus should be on a law that already exists and prosecutors use. Mortgage fraud perpetrators can be prosecuted under the Racketeer Influenced and Corrupt Organization Act (RICO) (Hutchins, 2011).[13]

The federal government must prove three elements to obtain a conviction under RICO. These elements are that the defendant: 1) through the commission of two or more acts constituting a pattern of racketeering activity; 2) directly or indirectly invested in, maintained an interest in, or participated in, an enterprise; and 3) which was engaged in, or the activities of which affected interstate or foreign commerce (Holt and Davis, 2009). A violation of RICO is punishable by a fine (twice the proceeds from a crime), up to 20

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[11] 42 U.S.C. §408(a)(7)(2010). This statute prohibits the use of false social security numbers for any purpose.

[12] 18 U.S.C. §1028. This law forbids the presentation or use of a falsified identification document or other identifying information that appears to have been issued by the United States.

[13] 18 U.S.C. §1961-68 (2010). Under RICO, it is
"… unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity … to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in or the establishment or operating of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce."

years in prison, or both, and asset forfeiture applies.[14] RICO has higher fines and longer prison sentences than other crimes used to prosecute mortgage fraud but also asset forfeiture.[15]

RICO is quite suitable for the prosecution of mortgage fraud since the statute's core elements align well with the crime of mortgage fraud. First, mortgage fraud often entails multiple conspirators acting in concert. Approximately 80 percent of all reported mortgage fraud losses involve collusion by industry insiders (FDLE, 2005). Two or more conspirators translates into an "association-in-fact enterprise" (a necessary element for a RICO offense) (Hutchins, 2011). Second, mortgage fraud involves a combination of bad acts. The latter produces a pattern of racketeering (Jacobson and Barnhill, 2008). RICO's reach was extended by federal prosecutors in the 1980s in white-collar cases including Drexel Burnham Lambert and Michael Milken and Marc Rich (Hutchins, 2011). Mortgage fraud cases would be a natural extension of the statute.

Besides more effective regulation and prosecution, a sixth step is to improve the education and understanding of regulators. First, adequate reporting systems are necessary so regulators become aware of potential mortgage fraud. The federal government can incentivize private organizations to police themselves and report suspicious activity. This approach has worked effectively with U.S. corporations in enforcement of the Foreign Corrupt Practices Act (FCPA). If a corporation suspected of bribery of a foreign government official does not have an FCPA compliance program,

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[14] 18 U.S.C. §1963(a)(2010). This means that on top of fining offenders twice their proceeds from a crime the government may also seize real estate, automobiles, boats, planes, artwork, electronics, etc. that have been purchased with proceeds of the crime. The government may place pre-trial restraints on such assets so they may not be secreted.
[15] 18 U.S.C. §1963(a)(1)-(3)(2010).

this may be interpreted as not having adequate internal controls. This is a separate prosecutable offense under the FCPA. Another example of incentivizing is the federal Sentencing Guidelines for Organization Offenders (Murphy, 2002). An organization convicted of a crime faces a significantly reduced sentence if it has an effective compliance program in place and cooperates with prosecutors.[16] Government agencies such as the SEC and Department of Health and Human Services have provided incentives to corporations to police themselves and increased penalties for those that did not voluntarily comply. The result is that many corporations have made a real effort to implement compliance programs (Valukas, 2010). Second, once regulators become aware of the conduct, they must understand the implications of those suspicious practices (Valukas, 2010). Forensic accountants who have the education and experience in handling mortgage and real estate fraud could be hired to educate regulators who deal with mortgage fraud. This could be accomplished through seminars and consultations and by having forensic accountants work as bank or mortgage examiners.

A seventh step is the pursuit of mortgage fraud prosecution at the state level. First, states should adopt a mortgage fraud law or similar legislation that would facilitate the investigation and prosecution of mortgage fraud. The passage of the Residential Mortgage Fraud Act in the state of Georgia is an important event in the state prosecution of mortgage fraud (Carswell and Bachtel, 2007). In a recent case in Atlanta, a jury handed down a 25-year sentence to a closing attorney involved in a mortgage fraud scam (Jones, 2007). In 2012, a new mortgage fraud law took effect in Michigan. Mortgage fraud is now a felony, and punishment includes up to 20 years in prison and a $500,000

[16] United States Sentencing Guidelines at §8C2.5(f).

fine (Franks, 2012). Other states are in the process of consideration of a mortgage fraud statute. Second, more enforcement and prosecutorial resources should be shifted to the prosecution of mortgage fraud offenders. Such a shift will heighten the need for forensic accountants to work with law enforcement and serve as expert witnesses on behalf of prosecutors and criminal defense attorneys.

An eighth step in the public sector response to combat mortgage fraud involves creation of a federal Office of Mortgage Fraud Enforcement, Interdepartmental Mortgage Fraud Task Forces, and an intergovernmental data sharing mechanism (MBA, 2007). An Office of Mortgage Fraud Enforcement, with centralized expertise, would target mortgage fraud. A lack of focus on mortgage fraud crimes has permitted such fraud to flourish. Interdepartmental task forces would enhance communication between federal and state authorities in the detection and prosecution of mortgage fraud. An intergovernmental shared database, which could be accessed and updated by federal and state authorities and mortgage lenders, would help prevent serial offenders from moving from one community to another using the same fraud schemes (MBA, 2007). Unfortunately, federal and state budget constraints have prevented funding such worthwhile initiatives.

Private Sector Means to Address Mortgage Fraud

It is certainly possible for the private sector to play an active role in addressing mortgage fraud issues. One means to pursue mortgage fraud is to make mortgage fraud victims more aware of private rights of action (or lawsuits) against mortgage fraudsters. Numerous legal theories, particularly under state law, can serve as the basis of a private right of action. Every state has a statutory and/or common law right of action for fraud.

Also, state laws creating private rights of action for unfair and deceptive acts and practices apply to mortgage fraud (MBA, 2007). For example, North Carolina's deceptive trade practices law creates a private right of action for "unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce."[17] The commission of any such act that injures a person or a business may be punished by treble (i.e., triple) damages and attorneys' fees.[18] Also, borrower-plaintiffs have convincing legal grounds to sue mortgage brokers who commit fraud under a theory of express or implied breach of fiduciary duty (Funkhouser, 2010). Clearly, a borrower reposes confidence in a broker to be its agent in dealing with a mortgage lender. In some states, such as Utah,[19] mortgage fraud may be deemed to involve securities fraud, giving the victim the right to seek rescission of any fraudulent transaction, attorneys' fees, and potential treble damages (Jacobsen and Barnhill, 2008).

Under federal law, injured parties can initiate a civil action against fraudsters under RICO. In addition to criminal offenses, any person "injured in his person or property" due to a RICO violation may institute a civil action and if successful, recover treble damages and attorneys' fees. Hence, legal theories abound for private rights of action against fraudsters. An increase of private mortgage fraud claims would mean a rise in demand for the services of forensic accountants as expert witnesses and litigation support consultants. The success of private sector involvement in the assault on mortgage fraud also requires the participation of private industry and professionals.

Private industry and professionals, such as realtors and appraisers, can play an

[17] N.C.G.S. §75-1.1(a)(2010).
[18] N.C.G.S. §75-16, 16-1 (2010).
[19] Utah Code Ann. §61-1-22 (2010).

active role in addressing mortgage fraud. Local realtors and lenders can inform and educate their members about the myriad ways one can unwittingly be drawn into a mortgage fraud scheme (Carswell and Bachtel, 2007). Realtors can disseminate information to prospective buyers and sellers on how to avoid becoming a mortgage fraud victim. Utility companies, such as electricity, water and natural gas suppliers, can also play a part as they are sometimes asked to identify mortgage fraud properties through sharing billing records (Carswell and Bachtel, 2007). A special role in the private sector can be played by appraisers.

Mortgage fraud is rampant so it behooves appraisers to be alert to suspicious activities or items. Merely following the Uniform Standards of Professional Appraisal Practice (USPAS) is not sufficient to fulfill the appraiser's responsibilities to clients and the public. Legal precedent exists for finding appraisers liable for losses caused by failure to verify information (Martin, 2009). In *FSLIC v. Texas Real Estate Counselors, Inc.,*[20] an appraiser was held liable for failing to verify the alleged completion of improvements and to disclose reliance on unverified data. In addition, Title XIV of the Dodd-Frank Act (15 U.S.C. §1639(h)) mandates that a residential appraiser be licensed in the state where the property is located, that an appraiser must do a physical visit of the interior of the property, that an appraiser may not disclose confidential information, that an appraiser has no direct, indirect, or prospective interest, financial or otherwise, in the property or transaction, and that the lender or real estate agent may not intimidate or bribe an appraiser. Certainly, forensic accountants or investigators can be utilized to enforce this by determining if an appraiser has any interest in the property being appraised and

[20] 955 F. 2d 261 (5th Cir. 1992).

can check for red flags of bribery.

The three areas where residential appraisal fraud is concentrated are fraudulent comparables, material omissions, and inflated values (MARI, 2010). Value inflation, however, is usually a direct consequence of incorrect, fabricated, or omitted comparables or other data (MARI, 2010). The determination of whether comparables are appropriate requires, at a minimum, an automated sales search based on underwriter criteria. Many finance professionals, including appraisers, can tell whether sales comparables are the closest, newest, and most similar to the property being appraised. Omissions are a more difficult area for appraisers.

The identification of omitted information, especially property characteristics and condition(s), is a difficult form of misrepresentation to detect or uncover. A whole host of unfavorable characteristics may be misrepresented by property owners including legality of use, availability of utilities, and property size (Martin, 2009). The appraiser should check with appropriate county authorities and local utilities to verify data supplied by the owner. Property size should be checked by actual measurement instead of relying on owner claims or county data sources. Property condition should be confirmed by the appraiser during physical inspection, including testing elevators, HVAC, and other equipment. Hidden encumbrances and environmental hazards are other conditions that may affect value (Martin, 2009). Again, the appraiser should check with the appropriate authorities to ensure against the existence of unknown encumbrances and undisclosed environmental damage. In sum, appraisers should be ready for dishonesty and biased or inaccurate information offered by various parties.

CONCLUSION

Mortgage fraud is rampant despite the improvement in the U.S. economy. Fraudsters engage in a diverse array of complex schemes to reap illicit profits at the expense of many victims. Such frauds include foreclosure rescue, home equity conversion, loan modification, illegal property flipping, builder bailouts, equity skimming, straw buyers, and short sales schemes. The different types of fraud schemes involve harmful actions by investors, mortgage brokers, builders, straw buyers, real estate agents, and appraisers, just to name a few. Each scheme carries its own set or list of red flags or warning signs. Fraud may not be present even though one red flag is present. Two or more red flags indicate a need for greater scrutiny. Often it takes a forensic accountant to find the presence of red flags.

Despite the increase in mortgage fraud, federal law enforcement authorities have not adequately responded with more vigorous enforcement. One reason is a shift of resources away from white-collar cases to anti-terrorism efforts. The federal response lacks interagency cooperation (e.g., task forces). In addition, state and local law enforcement have also not adequately addressed the mortgage fraud crisis.

Any effective counterattack against mortgage fraud and its damages requires the efforts of public and regulatory officials, private interests, and community organizations. The federal government has already reinstated tougher mortgage loan underwriting standards and improved regulation of mortgage brokers or originators. The NMLS for licensing registration will help fraud investigators track fraudsters across state lines. One improvement in regulation would be regular audits of the work product or files of mortgage lenders/brokers by federal and state bank examiners and forensic mortgage auditors. Another step involves the use of fines collected by the SEC and DOJ to hire more white-collar crime specialists. Moreover, more effective use of existing federal anti-fraud statutes, particularly RICO, would enhance mortgage fraud prosecution. RICO is quite suitable for mortgage fraud prosecution because the law's elements align well with the crime. Other public sector steps in the counterattack include enhanced regulator education and understanding and more vigorous state anti-fraud efforts and better intergovernmental cooperation.

In the private sector, one counterattack step is to heighten awareness of mortgage fraud victims about private rights of action against mortgage fraudsters. Numerous state law and federal legal theories are available for civil actions. Forensic accountants would play an important role in any increase in civil litigation against mortgage fraudsters. Private industry and professionals, such as realtors and appraisers, can assist in the assault on mortgage fraud. Appraisers, in particular, serve as gatekeepers or guardians against fraud. Appraisers can be held liable under federal and/or state law for negligence in doing appraisal work that does not meet legal standards.

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