# Ethics, Fair Lending, Fraud and Consumer Protection

## Overview

This course provides an ethical foundation and summary for Fair Lending Laws, a summary of fraud schemes and preventative measures and, lastly, focuses on a couple of key topics in Fair Lending. Specifically, this course includes the following modules

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# How Laws Enforce Ethics

## A. Why Are There Laws and Regulations?

The term ethics describes the topic, idea, study, analysis, and discussion of the criteria for assessing the appropriateness of behaviors, decisions, actions and/or positions. Some commonly cited ethical criteria might include culture, religion, philosophy, reason, logic, science, nature or business. Business ethics specifically applies to all aspects of business conduct and is relevant to the conduct of individuals and business organizations as a whole.

Ethics is a set of standards of right and wrong established by a particular group and imposed on members of that group as a means of regulating and setting limits on their behavior. The word ethics comes from the Greek word *ethos* which is a 'cultural custom' or 'habit.'

Relying on personal ethical actions is not always easy in an economy driven by bottom line profits. Though unethical behavior has harmful repercussions and most people would choose to follow an ethical path if given the choice, the wrong incentives can cause a conflict of interest.

The impact of the lender's actions could damage a borrower, the community, the institution or the business of other competitors. An appropriate law will create an incentive to protect those people who are harmed by the action. The appropriate law would reinforce a person's conscience by enforcing direct repercussions for unethical behavior. It would also level the playing field by ensuring that all market participants play by the same rules.

It is the responsibility of each person involved in a loan transaction to align incentives with ethical behavior. Laws are a critical link in that chain.

## B. How Do Laws Help?

Several components of laws reinforce ethical behavior.

**Definitions**. Laws lay out specific definitions of whom or what is affected by its various requirements. In other words, the laws give concrete language to less tangible knowledge about unethical ideas. Though everyone "feels" or even knows something is unethical, it is very helpful to have specific metrics and requirements, which are presented in laws.

For example, Inflated Appraisals are unethical, but how does one determine where to draw the line between what could be a reasonable increase in price and what could be inflated? Many times we may feel we know the line and err on the conservative side to make sure, but legal definitions can also help guide us to a decision.

**Disclosures**. Laws generally stipulate that brokers, lenders and other industry participants disclose certain items to the public or to each other through official documents. Many times, a signature of attestation is required in order to assure that the appropriate parties have read and understood the information in the disclosure.

Such disclosures require that all parties assent to the terms mentioned and that such terms are disclosed as needed. For example, the Good Faith Estimate is an official disclosure that shows all of the various fees to a borrower. It makes sure that the borrower is completely aware of what they will be paying and why. It also assures the underwriter and/or broker that the borrowers are making informed decisions.

**Enforcement Provisions**. Laws generally delegate responsibility for the enforcement and the creation of regulations to various agencies. The laws thus give organizations the authority to take action against those who violate laws. The FBI and the Financial Crimes and Enforcement Network (FinCEN) defines mortgage fraud as "… the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan."

The Consumer Financial Protection Bureau has regulatory and enforcement authority over providers of consumer financial products, including mortgage lenders. State Regulators and Examiners represent another example of legally mandated enforcement provisions. Knowledge and understanding that an examiner could show up on one's doorstep at anytime certainly helps enforce behavior to conform to regulations and industry-specific laws.

**Operational Requirements**. Laws help to implement processes that allow industry regulators and participants to gain more information about a situation or person. The SAFE Act requires MLOs to get a fingerprint card and complete an FBI background check as well as attest to any former felonies, license suspensions or revocations and submit a financial statement/credit report. This information contributes to an agency's analysis of complaints or evidence of unethical behavior.

# C. Federal Laws and Applicability

### *Real Estate Settlement Procedures Act (RESPA).*[1]

Enacted in 1974, RESPA was aimed at preventing settlement service providers from generating unearned fees using unethical business practices. RESPA has a number of requirements regarding fees and how they are either presented or distributed. The rule-making authority for RESPA was transferred to the Consumer Financial Protection Bureau effective July 21, 2011. The CFPB is proposing to amend Reg. X to establish new requirements for most closed-end consumer credit transactions secured by real property. As a Mortgage Originator you are responsible to know the current law, what is proposed and when the new rules will take effect. You can find all regulations on the Consumer Protection Finance Bureau website here: http://www.consumerfinance.gov/regulations/ The general theme in RESPA is that earned fees must be commensurate with the amount value of the work. Some of the specific areas of focus for RESPA are kickbacks, markups and affiliated business arrangements.

**Kickbacks**. RESPA prohibits anyone from giving or accepting "anything of value" for the referral of mortgage business. This rule broadly applies to all fees, kickbacks and even free sports tickets. The key question is whether any value given is related to a service provided. Additionally, if there is a service, then the value given must be equivalent to the market value of the service provided.

**Markups**. RESPA prohibits one settlement service provider increasing the fee charged by another provider while retaining the additional fees. This means that actual third-party fees cannot be increased on the GFE and HUD1 so that the lender or MLO retains any portion of that fee.

**Affiliated Business Arrangements**. RESPA prohibits affiliated business arrangements when they are established for the sole purpose of disguising a fee-splitting scheme. Referrals between affiliated businesses are considered legal when the referrals help borrowers obtain services necessary for the completion of a lending transaction.

For these legal affiliated business arrangements, the referrals cannot be required.

For example, a specific title insurance company can be suggested by the lender, the broker or the MLO, but other title companies should be listed and the borrower must have complete

[1] RESPA (Regulation X) CFBP Section 12 CFR 1024

leeway in choosing providers. Furthermore, there are specific disclosures that must be made to the borrower regarding the arrangement. Lastly, there are several rules that determine what compensation may be given or received by a referral partner.

Because these arrangements can be complex and attempts to evade the rules with sham arrangements are always a possibility, HUD created a policy statement on "Sham Controlled Business Arrangements." The statement outlines a number of factors needed for a business arrangement to be deemed valid. One of these factors involves establishing the existence and authenticity of the entities involved using a variety of documents and tests, such as whether the entity has employees, is capitalized, etc…

We've included an example of the Affiliated Business Arrangement disclosure (often referred to as the ABA) taken from the HUD website. It is made explicit in the Affiliated Business Arrangement disclosure that the customer is not required to use the lender's MLOs referred services and can shop around:

*"THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THESE SERVICES."*

## APPENDIX D TO PART 1024—AFFILIATED BUSINESS ARRANGEMENT DISCLOSURE STATEMENT FORMAT

*Affiliated Business Arrangement Disclosure Statement Format Notice*

To: ________________________
From: ________________________
(Entity Making Statement)
Property: ________________________
Date: ________________________

This is to give you notice that [*referring party*] has a business relationship with [*settlement services provider(s)*]. [Describe the nature of the relationship between the referring party and the provider(s), including percentage of ownership interest, if applicable.] Because of this relationship, this referral may provide [*referring party*] a financial or other benefit.

[A.] Set forth below is the estimated charge or range of charges for the settlement services listed. You are NOT required to use the listed provider(s) as a condition for [settlement of your loan on] [or] [purchase, sale, or refinance of] the subject property. THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THESE SERVICES.

[*provider and settlement service*] ____________

[*charge or range of charges*] ____________

[B.] Set forth below is the estimated charge or range of charges for the settlement services of an attorney, credit reporting agency, or real estate appraiser that we, as your lender, will require you to use, as a condition of your loan on this property, to represent our interests in the transaction.

[*provider and settlement service*] ____________

[*charge or range of charges*] ____________

ACKNOWLEDGMENT

I/we have read this disclosure form, and understand that *referring party* is referring me/us to purchase the above-described settlement service(s) and may receive a financial or other benefit as the result of this referral.

________________________
Signature

[INSTRUCTIONS TO PREPARER:] [Use paragraph A for referrals other than those by a lender to an attorney, a credit reporting agency, or a real estate appraiser that a lender is requiring a borrower to use to represent the lender's interests in the transaction. Use paragraph B for those referrals to an attorney, credit reporting agency, or real estate appraiser that a lender is requiring a borrower to use to represent the lender's interests in the transaction. When applicable, use both paragraphs. Specific timing rules for delivery of the affiliated business disclosure statement are set forth in 12 CFR 1024.15(b)(1) of Regulation X). These INSTRUCTIONS TO PREPARER should not appear on the statement.]

## APPENDIX E TO PART 1024—ARITHMETIC STEPS

### I. EXAMPLE ILLUSTRATING AGGREGATE ANALYSIS

*Assumptions*

Disbursements:

$360 for school taxes disbursed on September 20

$1,200 for county property taxes:
$500 disbursed on July 25
$700 disbursed on December 10

Cushion: One-sixth of estimated annual disbursements

Settlement: May 15

First Payment: July 1

STEP 1—INITIAL TRIAL BALANCE

| | Aggregate | | |
|---|---|---|---|
| | pmt | disb | bal |
| Jun | 0 | 0 | 0 |
| Jul | 130 | 500 | −370 |
| Aug | 130 | 0 | −240 |
| Sep | 130 | 360 | −470 |
| Oct | 130 | 0 | −340 |
| Nov | 130 | 0 | −210 |
| Dec | 130 | 700 | −780 |
| Jan | 130 | 0 | −650 |
| Feb | 130 | 0 | −520 |
| Mar | 130 | 0 | −390 |
| Apr | 130 | 0 | −260 |
| May | 130 | 0 | −130 |
| Jun | 130 | 0 | 0 |

STEP 2—ADJUSTED TRIAL BALANCE

[Increase monthly balances to eliminate negative balances]

| | Aggregate | | |
|---|---|---|---|
| | pmt | disb | bal |
| Jun | 0 | 0 | 780 |
| Jul | 130 | 500 | 410 |
| Aug | 130 | 0 | 540 |
| Sep | 130 | 360 | 310 |
| Oct | 130 | 0 | 440 |
| Nov | 130 | 0 | 570 |
| Dec | 130 | 700 | 0 |
| Jan | 130 | 0 | 130 |
| Feb | 130 | 0 | 260 |

**Mishandling of Borrowers' Funds**. RESPA prohibits commingling, conversion or misappropriation of borrower funds. Regulation X expands on this by laying out specific processes for managing the funds after closing, for calculating the various changes and impacts on escrow accounts and for reporting.

**Limits on Escrow Accounts**. RESPA sets limits on the amounts that a lender may require a borrower to put into an escrow account for purposes of paying taxes, hazard insurance and other charges related to the property. RESPA does not require lenders to impose an escrow account on borrowers; however, certain government loan programs or lenders may require escrow accounts as a condition of the loan.

During the course of the loan, RESPA prohibits a lender from charging excessive amounts for the escrow account. Each month, the lender may not require a borrower to pay into the escrow account more than the sum of (1) a monthly payment average, or specifically, 1/12th of the total of all disbursements payable during the year and (2) an amount necessary to pay for any shortage in the account.

In addition, the lender may require a cushion in the account, not to exceed an amount equal to 1/6 of the total disbursements for the year. The lender must perform an escrow account analysis once a year and notify borrowers of any shortage. If it turns out that there is an excess of $50 or more in the account and the borrower is current on payments, the amount must be returned to the borrower. If the borrower is late on payment, the excess does not need to be returned.

## *Truth In Lending Act (TILA)/Regulation Z.[1] and Mortgage Acts And Practices—Advertising (Regulation N)[2].*

Regulation N was originally the Omnibus Appropriations Act, Its rule-making authority was transferred from the FTC to the Consumer Financial Protection Bureau effective July 21, 2011. The rule-making authority for TILA was also transferred to the Consumer Financial Protection

[1] Source: Truth in Lending Act (Regulation Z) CFPB Section 12 CFR 1026.
[2] MORTGAGE ACTS AND PRACTICES—ADVERTISING (REGULATION N) CFR 12 Part §1014.1-7

Bureau effective on the same day. The most important impacts of TILA §1026.24 (Advertising) and Regulation N regarding ethical behavior are their definitions and enforcement requirements for misleading advertising. As a Mortgage Originator, you are responsible to know the current law, what is proposed and when the new rules will take effect. You can find all regulations on the Consumer Protection Finance Bureau website here: http://www.consumerfinance.gov/regulations/

A common ethical problem in mortgage lending is the advertising of loan products which brokers / lenders cannot really offer or which are deceptive. One question might be, what exactly is considered advertising? Regulation N Part 1014.2 clarifies the meaning of advertising by giving this definition: *"Commercial communication means any written or oral statement, illustration, or depiction, whether in English or any other language, that is designed to effect a sale or create interest in purchasing goods or services, whether it appears on or in a label, package, package insert, radio, television, cable television, brochure, newspaper, magazine, pamphlet, leaflet, circular, mailer, book insert, free standing insert, letter, catalogue, poster, chart, billboard, public transit card, point of purchase display, film, slide, audio program transmitted over a telephone system, telemarketing script, on-hold script, upsell script, training materials provided to telemarketing firms, program-length commercial ("infomercial"), the internet, cellular network, or any other medium. Promotional materials and items and Web pages are included in the term commercial communication."*[1]

The Federal Trade Commission (FTC) and the CFPB have created a list of deceptive and misleading practices in the advertisement of closed-end mortgage loans. Regulation Z requires the additional information to be included whenever a trigger term, such as "assume a mortgage note rate of 7 percent," is used in advertising.

Under Reg. Z, Reg. N and other associated regulations, industry participants can only advertise lending terms that are actually available. Reg. N also prevents lenders from misleading consumers by providing incomplete information about loan products.

For example, an MLO cannot advertise a rate that is not available to applicants who meet underwriting and program guidelines. Additionally, any advertised rate or loan term should be available to a significant portion of applicants, and not to a very limited segment of consumers only.

[1] MORTGAGE ACTS AND PRACTICES—ADVERTISING (REGULATION N) CFR 12 § 1014.2 Definitions.

The clear message of both TILA and Reg. N is that the advertising of loan products and terms that are not actually available is dishonest and unethical. In order to clarify this message, Reg. Z creates a list of "trigger terms" for the extension of credit, which require the need for additional disclosure. The trigger terms vary according to the type of loan being advertised.

Trigger Terms for Closed-End Loans

Trigger terms for closed-end loans include:

- Amount or percentage of any down payment
- Number of payments or period of repayment
- Amount of any payment
- APR

If an ad states a finance charge, it must state the rate as an APR. If any trigger term is used, then the ad must clearly and conspicuously disclose:

- Amount and percentage of the down payment
- Terms of repayment, including any balloon payment
- APR and whether the APR is likely to increase

When an ad states any information on credit, it must also include:

- The amount of each payment that will apply over the term of the loan, including any balloon payment
- The time period that each payment will apply
- An indication that the payment does not include taxes and insurance, in cases where the ad is for a first-lien mortgage

Trigger Terms - ARM Loans

If an ad provides a simple rate of interest and more than 1 rate will apply during the term of the loan, the ad must contain the following "with equal prominence and in close proximity" to the advertised rate:

- Each simple annual rate of interest that will apply
- The period of time for which the interest rate will apply
- The APR
- The rate as an APR, in cases where the ad states a finance charge

Trigger Terms - Home Equity Plans

Trigger terms for home equity loans include reference to any of the following:

- Finance charge
- Real-estate transaction fees, such as appraisal, title, credit report, and closing fees
- Payment terms
- Any other terms presented in a TIL disclosure statement

Including any information in an ad about these lending terms and fees triggers a requirement to clearly and conspicuously include the below points:

- Any loan fee that is a percentage of the credit limit
- An estimate, stated in a dollar amount, of any fee to open the plan and the APR
- The max APR that may be imposed under a variable rate loan
- The time period during which the promotional rate or payment applies
- The amount and time periods of any payment that will apply under the home equity plan

Additionally, statements must be given with equal prominence and in close proximity.

Discounted and Premium Rates

A discounted or promotional rate is an initial APR that is not based on the index and margin used to make rate adjustments to an ARM. When advertising a discounted or premium rate, there is a trigger requiring inclusion of the following information:

- The period of time during which the discount or premium rate will be in effect
- A reasonably current APR for the loan, if it were fully indexed. This must be in equal prominence and close proximity to the discount rate

**Example**: 6.5% for the first six months! After six months, the APR is 10.5% (as of May 1), subject to increase based on market conditions.

*NOTE: This example only refers to the rules of the rate change. Other information such as terms of payment and down payment are also required, as with other loans.*

Prohibitions in Advertising

In 2008, revisions were made to Reg. Z by the Federal Reserve to identify misleading and deceptive practices in the advertisement of closed-end mortgage loans. The following lists 7 prohibited acts:

- Misleading advertising of "fixed" rates and payments: mortgages may combine a fixed period and a variable period, like a conforming 5/1 ARM. These loans cannot be called fixed or fixed-period loans.
- Misleading comparisons in advertisements: comparing an advertised hypothetical mortgage such as "save $400 per month on a $350,000 mortgage"
- Misrepresentations about government endorsement: statements that may lead consumers to believe a mortgage is endorsed by the government
- Misleading use of the current lender's name: this may lead a consumer to believe that their own lender is contacting them with information on mortgage products
- Misleading claims of debt elimination: suggesting that a consumer can obtain a waiver of their obligation to another creditor ("Refinance today and get rid of all debt!").
- Misrepresentations use of the term "counselor": the term "counselor" cannot refer to a for-profit lender, broker, MLO or any other employee
- Misleading foreign language advertisements: putting favorable terms in one language and less favorable terms in another language

Minimum Payments

Advertising a minimum payment triggers a requirement to include a statement (if applicable) that a balloon payment may result. Even if a balloon payment is uncertain or unlikely, including a minimum payment requires that the advertiser state, with equal prominence and in close proximity, that a balloon payment may result. If a balloon payment will occur only if a minimum or non-amortizing payment is made, a statement must state, in close proximity and equal prominence, that a balloon payment will result.

**Regulation N § 1014.3 Prohibited Representations** says it is a violation for any person to make any material misrepresentation regarding any term of any mortgage credit product. These include but are not limited to misrepresentations regarding the:

- Term
- Interest charged
- Interest owed
- APR and any other rate
- Costs

- Fees
- Payments
- Charges
- Potential for default.

It prohibits material misrepresentations regarding the association of the mortgage credit product or any provider:

- With any other person or program such as a governmental entity or other organization
- That the product is endorsed, sponsored by, or affiliated with any government or other program
- That the communication comes from the consumer's current lender
- Material misstatements about the rights of consumers are prohibited

For example: Mortgage Originator Jane wants to advertise her services to First Time Homebuyers through her website, Facebook page and printed media. She knows that many first-time buyers want additional education and information and she wants to let people know that she can provide that information. Jane must be sure to avoid making statements like "I am a HUD-approved counselor", or "I am an FHA loan officer".

§ 1014.5 Recordkeeping requirements: Records must be kept for 24 months.

§ 1014.6 Actions by states: Enforced by the Attorney General of any State and the Consumer Financial Protection Bureau.[1]

## *Equal Credit Opportunity Act (ECOA) and Fair Housing Act.*[2]

Enacted in 1974 and 1968 respectively, both acts aim at preventing discrimination in credit decisions.

The rule-making authority for ECOA was transferred to the Consumer Financial Protection Bureau effective July 21, 2011. As a Mortgage Originator, you are responsible to know the current law, what is proposed and when the new rules will take effect. You can find all

[1] PART 1014—MORTGAGE ACTS AND PRACTICES—ADVERTISING (REGULATION N)
[2] Source: *Equal Credit Opportunity Act (Regulation B) CFPB Section 12 CFR 1002.*

regulations on the Consumer Protection Finance Bureau website here: http://www.consumerfinance.gov/regulations/

Though not as common as it once was in the mortgage industry, prejudices can cause unethical business practices whereby lenders will not give creditworthy borrowers credit. Some of the specific circumstances leading to the enactment of ECOA regarded women being unequally treated in obtaining credit. A more common example that might be applicable today would be denying credit to an applicant on the sole basis of their receipt of public assistance.

The driving force behind ECOA was "…largely anecdotal evidence that women were not treated on an equal basis with men in credit markets, particularly in mortgage credit markets." Peterson, Richard. "An investigation on Sex Discrimination in Commercial Banks Direct Consumer Lending." Bell Journal of Economics, Vol. 12, No. 2 Autumn 1981, page 547

The laws and their associated regulations prohibit industry participants from engaging in the unethical practice of discrimination. These legislations are intended to promote the availability of credit to all creditworthy applicants regardless of race, color, religion, national origin, sex, marital status, or age, and regardless of the fact that the applicant has income from a public assistance program, or that the applicant has exercised his/her rights under the Consumer Credit Protection Act.

## *Gramm-Leach-Bliley Act (GLB).*[1]

Enacted in 1999, the GLB Act is aimed at protecting the privacy of consumers' personal information. Specifically, a number of cases of unauthorized and profitable sale of personal information by financial institutions led to the enactment of this act. The rule-making authority for GLB was transferred to the Consumer Financial Protection Bureau effective July 21, 2011.

GLB requires disclosure detailing a broker's / lender's practices regarding the sharing of nonpublic personal information. This disclosure document must enable the consumer to opt out from the sharing of nonpublic personal information. GLB also requires brokers and lenders that receive personal information to maintain the proper safeguards for confidentiality, including the storage and disposal of consumers' personal information. These safeguards are detailed by the FTC.

[1] Source: Gramm-Leach-Bliley Act (Regulation P) CFPB Section 12 CFR 1016

### *Home Ownership and Equity Protection Act (HOEPA).*[1]

HOEPA, which was enacted in 1994 and amended TILA, is aimed at preventing situations where the primary victim of mortgage fraud is the borrower. The law is a key instrument in preventing predatory lending. HOEPA applies broadly but also addresses predatory lending that is generally connected to high-interest loans. The next section contains additional information on predatory lending and HOEPA.

### *Fair Credit Reporting Act.*[2]

Enacted in 1970, the primary purpose of the FCRA is to ensure the accuracy, fairness and privacy of personal information used by consumer reporting agencies. In addition, under the FCRA, users must provide credit reporting agencies with a certification of permissible purpose when requesting credit reports. Furthermore, if some harmful action is taken (such as turning down a loan application) because of the information contained in a credit report, the broker or lender has to provide a "Notice to the Home Loan Applicant Notification of Adverse Action."

### *Red Flag Rule.*

Upon the enactment of the Red Flag Rule in FACTA in 2004, the FTC (Federal Trade Commission) was charged with creating regulations to implement the law. As many as nine million Americans have their identities stolen each year. Identity thieves may drain bank accounts, damage credit worthiness, and may even endanger future medical treatment. The Red Flag Rule aims at protecting consumer information and preventing identity theft by requiring financial institutions to develop and implement identity-theft prevention programs.

The Red Flag Rule is enforced by the Federal Trade Commission (FTC), the various federal bank regulatory agencies, and the National Credit Union Administration. This regulation covers a broad selection of financial institutions. Although the specific companies covered are still subject to debate, mortgage brokers and lenders are unequivocally covered by the legislation.

[1] Source: Home Ownership and Equity Protection Act (Amendment to Truth in Lending Act (Regulation Z) CFPB Section 12 CFR 1026.
[2] Source: Fair Credit Reporting Act (Regulation V) CFPB Section 12 CFR 1022

## *Appraiser Independence Requirements (AIR) / Valuation Independence*[1]

TILA in subsection 1026.42 makes it illegal for a lender or originator to influence the outcome of an appraisal in any consumer transaction secured by a principal dwelling. When it comes to good ethics practice, AIR:

Prohibits lenders and third parties (particularly mortgage loan originators) from influencing the appraisal process and outcome through coercion or mischaracterization of value.

- Requires lenders to provide borrowers with a copy of the appraisal no less than 3 days before closing.
- Requires lenders or lender-authorized third parties to select and pay appraisers.
- Requires absolute independence within a lender's organization between the appraisal function and loan production while also limiting communication with the appraiser. These same restrictions apply to a lender's in-house appraisal function.
- Requires lenders to conduct training as well as implement written policies, procedures and disciplinary rules on appraiser independence.

## *The Appraisal Subcommittee of Federal Financial Institutions Examination Council*

The Appraisal Subcommittee has been charged with overseeing the development of uniform state licensing and appraisal standards, including appraisal standards for federally-licensed mortgage lenders, and with monitoring the development of a national database of certified appraisers.[2] These standards now appear in a variety of state laws and agency guidelines. The goal is to reduce both appraisal fraud and the prevalence of unsupportable valuations.

Critical to these appraisal standards is the prohibition of "undue influence" upon the independent judgment of an appraiser by anyone involved in the transaction. No MLO, or other industry insider, may take any action to influence the value established by the appraiser, other than to provide valid information. An MLO may not volunteer a value, suggest the value needed to make the transaction possible, or pressure the appraiser with promises of additional work or the threat of lost work.

[1] Truth in Lending Act CFPB Section 12 CFR 1026.42 Valuation independence.
[2] Pub. L. 101-73, title XI, Sec. 1101

# D. Real World Impacts

As mentioned above, the laws exist to align business incentives with moral and ethical objectives. Compliance with the laws requires a knowledge and understanding of those actions which may be harmful to others as well as a general understanding of morality and ethical standards. The laws are created with certain ethical standards in mind, the majority of which are related to the protection of those who would be harmed by unethical practices.

Penalties imposed by courts for the violation of mortgage lending laws can be severe. For example, violations of the GLB Act could result in a civil penalty of up to $100,000 for each infringement. Even in settlement agreements with enforcement agencies, there are likely to be additional requirements around disclosure, future monitoring of and reporting to the agencies and increased compliance activity and recordkeeping.

Criminal penalties can also be severe. For example, violation of RESPA with regards to kickbacks can result in up to one-year imprisonment and revocation of a mortgage broker's license, along with any relevant fines. Certain violations of FCRA can also lead to criminal penalties.

Compliance with these laws and the respect of ethical business practices are key to avoiding potentially serious financial or criminal penalties, the need for additional reporting and recordkeeping, as well as costly compliance expenditures.

# Laws that Prevent Illegal Discrimination

## A. Overview and Discriminatory Actions

Discrimination is the unjust or prejudicial treatment of different categories of people or things, especially on the grounds of race, age, or sex.[1] The effects of discrimination in housing are widespread. Even in this day and age discrimination in housing and real estate is having a negative impact on our country and communities. When people are not offered the same opportunities to equal access to the housing of their choice, it violates the principles of freedom and opportunity that we cherish as the cornerstone of our American Dream.

The National Fair Housing Alliance (NFHA) estimates in their Fair Housing Trends Report 2012 that, "private fair housing organizations, Fair Housing Assistance Programs, the Department of Housing and Urban Development, and the Department of Justice collectively reported 28,519 complaints of discrimination in housing, an increase from 2011."[2]

Federal Fair Housing, Federal Fair Lending as well as state and local laws make it illegal to discriminate in real estate and housing transactions against a person who is in a protected class. Federal Fair Housing and Federal Fair Lending Law currently defines protected classes as: race, color, religion, sex, disability, familial status, or national origin. There are plans to expand that definition to include: source of income, sexual orientation, gender identity, and marital status.

States and local agencies have enacted unfair and deceptive acts and practices laws (UDAP) to further protect consumers. UDAP laws make it illegal to engage in unfair or deceptive practices in consumer transactions. In some cases, they have also expanded the definition and protections of protected classes of people within their jurisdictions.

"The following chart lays out the complaint and case filings reported by private and governmental fair housing agencies and organizations in 2012. Fair Housing Assistance Program (FHAP) organizations are state and local government agencies that receive HUD funding to investigate fair housing complaints. According to the Fair Housing Act, HUD is required to

[1] http://oxforddictionaries.com/us/definition/american_english/discrimination
[2] http://www.nationalfairhousing.org/Portals/33/2013_Fair_Housing_Trends_Report.PDF

refer cases to these agencies if the agencies are 'substantially equivalent' under the law, i.e. that the state or local law offers protections equivalent to the federal law. NFHA counts as complaints all cases analyzed for fair housing violations. "

| TOTAL FAIR HOUSING COMPLAINTS FILED | | | | | |
|---|---|---|---|---|---|
| | NFHA Member Complaints | FHAP Claims & Complaints | HUD Claims & Complaints | DOJ Case Filings | Total |
| 2003 | 17,022 | 5,352 | 2,745 | 29 | 25,148 |
| 2004 | 18,094 | 6,370 | 2,817 | 38 | 27,319 |
| 2005 | 16,789 | 7,034 | 2,227 | 42 | 26,092 |
| 2006 | 17,347 | 7,498 | 2,830 | 31 | 27,706 |
| 2007 | 16,834 | 7,705 | 2,449 | 35 | 27,023 |
| 2008 | 20,173 | 8,429 | 2,123 | 33 | 30,758 |
| 2009 | 19,924 | 8,153 | 2,091 | 45 | 30,213 |
| 2010 | 18,665 | 8,214 | 1,943 | 29 | 28,851 |
| 2011 | 17,701 | 7,551 | 1,799 | 41 | 27,092 |
| 2012 | 19,680 | 6,986 | 1,817 | 36 | 28,519 |

As a mortgage originator it is important to understand how this illegal discrimination can impact consumers, your company and, most importantly, your business and reputation. In this chapter, we will concentrate on Fair Housing and Fair Lending Laws that affect the mortgage industry and real estate.

It is your responsibility to know the law! *Remember you must not only fulfill the letter of the law but the intent of the law as well.*

# B. Fair Housing Laws

### *The Civil Rights Act of 1866*

The Civil Rights Act of 1866 was the first law to extend rights to all citizens of the United States. This act states that all persons born in the United States are citizens of the United States.

Furthermore, the act confers to them the right to inherit, purchase, lease, sell, hold, and convey real and personal property whatever their race or color. It extends equal benefit of all laws and proceedings for the security of person and property, as is enjoyed by white citizens. The Civil Rights Act of 1866 applies to all property, real or personal, including residential or commercial property.

Title VI of the Civil Rights Act of 1964 (Title VI) prohibits discrimination on the basis of race, color, or national origin in programs and activities receiving federal financial assistance.

### *The Fair Housing Act*

Title VIII of the Civil Rights Act of 1968 (Fair Housing Act), as amended, prohibits discrimination in the sale, rental, and financing of dwellings, and in other housing-related transactions, based on race, color, national origin, religion, sex, familial status (including children under the age of 18 living with parents or legal custodians, pregnant women, and people securing custody of children under the age of 18), and disability.

The Secretary of Housing and Urban Development has the authority to administer and enforce Title VIII of the Civil Rights Act of 1968, as amended by the Fair Housing Amendments Act of 1988 (the Fair Housing Act). In addition, HUD also has general rule-making authority for Fair Housing under the Department of Housing and Urban Development Act.

The Fair Housing Act sets clear standards for legal and ethical behavior surrounding housing and real estate transactions. This includes the lease, rental or sale of residential dwellings. Almost all housing is covered under the Fair Housing Act.

Don't discriminate!

**What Is Prohibited?**

***In the Sale and Rental of Housing, no one may take any of the following actions based on race, color, national origin, religion, sex, familial status or handicap:***

- Refuse to rent or sell housing after a good faith offer has been made
- Refuse to negotiate in the sale or rental of housing
- Make housing unavailable, when it is actually available
- Deny a dwelling because someone is in a protected class
- Set different terms, conditions or privileges for sale or rental of a dwelling
- Provide different housing services or facilities
- Falsely deny that housing is available for inspection, sale, or rental
- For profit, persuade owners to sell or rent (blockbusting) or
- Deny anyone access to or membership in a facility or service (such as a multiple listing service) related to the sale or rental of housing.

***In Addition, it is illegal for anyone to:***

- Threaten, coerce, intimidate or interfere with anyone exercising a fair-housing right or assisting others who exercise that right

- Advertise or make any statement that indicates a limitation or preference based on race, color, national origin, religion, sex, familial status, or handicap. This prohibition against discriminatory advertising applies to single-family and owner-occupied housing that is otherwise exempt from the Fair Housing Act.

***Additional safeguards exist for individuals who:***

- Have a physical or mental disability (including hearing, mobility and visual impairments, chronic alcoholism, chronic mental illness, AIDS, AIDS-Related Complex and mental retardation) that substantially limits one or more major activities of daily living
- Have a record of such a disability or
- Are regarded as having such a disability[1]

**Exemptions**

There are some exemptions to the Fair Housing Act. It does not apply to:

1. The sale or rental of a single-family residence by a private owner as long as:
a. They do not own more than three properties
b. They did not use a real estate broker or salesperson
2. The rental of four rooms or less in a property where the owner occupies one of the rooms
3. A religious organization, a non-profit religious organization or a private club as long as they are not discriminating in membership.

Note: the familial status provision does not apply to approved programs operating to assist elderly people.

## Fair Housing and Advertising[2]

It is illegal to make any statement or advertisement with respect to the sale or rental of a dwelling which indicates any preference, limitation or discrimination based on someone being in a protected class. This provision regarding advertising includes words, phrases, photographs, illustrations, symbols or forms which convey that dwellings are available or not available to a particular group of people. Fair Housing Law clearly stipulates that statements and advertising includes all forms of consumer communication including applications, flyers, brochures, deeds, signs, banners, posters, billboards, documents as well as electronic media such as web sites and Facebook. Remember that "***This prohibition against discriminatory advertising applies to***

[1] **Fair Housing And Equal Opportunity** http://portal.hud.gov/hudportal/HUD?src=/program_offices/fair_housing_equal_opp/FHLaws/yourrights
[2] Fair Housing Act CFR 24 PART 100—DISCRIMINATORY CONDUCT UNDER THE FAIR HOUSING ACT § 100.75 Discriminatory advertisements, statements and notices

***single-family and owner-occupied housing that is otherwise exempt from the Fair Housing Act."*** When you advertise you must include the Equal Opportunity logo in your advertisement. This logo should be on all public-facing communication.

EQUAL HOUSING
OPPORTUNITY

## Fair Housing and Loans[1]

The Fair Housing Act sets clear standards for the legal treatment of consumers in real estate related transactions including mortgage lending. Treating people equally and fairly is the cornerstone of a good mortgage business. Fair Housing Laws and Fair Lending Laws combine to create strong protections in our financial markets. Let's review the prohibitions in Fair Housing Laws as they relate to mortgage lending:

Section § 100.120[2] states that any person engaged in residential real estate-related transactions may not discriminate against any person *"in making available loans or other financial assistance for a dwelling, or which is or is to be secured by a dwelling" because they are in a protected class.*

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[1] Fair Housing Act CFR 24 PART 100—DISCRIMINATORY CONDUCT UNDER THE FAIR HOUSING ACT § 100.120 Discrimination in the making of loans and in the provision of other financial assistance

[2] Fair Housing Act CFR 24 PART 100—DISCRIMINATORY CONDUCT UNDER THE FAIR HOUSING ACT § 100.120 Discrimination in the making of loans and in the provision of other financial assistance

*Prohibitions include but are not limited to:*

- Refusing to make a mortgage loan
- Refusing to provide information regarding loans
- Imposing different terms or conditions on a loan, such as different interest rates, points, or fees

- Discriminating when appraising property
- Refusing to purchase a loan *or*
- Setting different terms or conditions for purchasing a loan.

Using the fact that someone is in a protected class to impose different policies, practices or procedures in evaluating or in determining creditworthiness of any person regarding a loan or financial assistance for a dwelling is a prohibited practice.

The Fair Housing Poster is required to be posted conspicuously wherever residential real estate for sale, rent, or financing is made available to the home-seeking public. This poster is used to inform them that a dwelling is available to any person regardless of their race, color, religion, sex, handicap, familial status, or national origin.

EQUAL HOUSING
OPPORTUNITY

## We Do Business in Accordance With the Federal Fair Housing Law

(The Fair Housing Amendments Act of 1988)

## It is illegal to Discriminate Against Any Person Because of Race, Color, Religion, Sex, Handicap, Familial Status, or National Origin

- In the sale or rental of housing or residential lots
- In advertising the sale or rental of housing
- In the financing of housing
- In the provision of real estate brokerage services
- In the appraisal of housing
- Blockbusting is also illegal

Anyone who feels he or she has been discriminated against may file a complaint of housing discrimination:

1-800-669-9777 (Toll Free)
1-800-927-9275 (TTY)

U.S. Department of Housing and Urban Development
Assistant Secretary for Fair Housing and Equal Opportunity
Washington, D.C. 20410

Previous editions are obsolete

form HUD-928.1 (2/2003)

# C. Fair Lending Laws

## *Equal Credit Opportunity Act (ECOA)*

Regulation B is a major law in terms of Fair Lending. The purpose of ECOA is *"to promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status or age (provided the applicant has the capacity to contract); to the fact that all or part of the applicant's income derives from a public assistance program; or to the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act."* [1] *ECOA stipulates required actions that must be taken to assure consumers that a creditor is acting in their best interest and is not acting in a discriminatory fashion against them.*

ECOA covers all consumer credit including credit issued by banks, credit unions, finance companies, credit card companies, retail stores, department stores, student loan lenders, mortgage companies and brokers. In other words, ECOA applies to anyone involved in granting credit.

*The Consumer Financial Protection Bureau has rule-making and enforcement authority for ECOA.* The Office of Fair Lending and Equal Opportunity at the CFPB helps ensure that all Americans have fair, equitable, and nondiscriminatory access to credit. However, each creditor also has their own administrative enforcement agency assigned to it. These are: the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Surface Transportation Board, the Civil Aeronautics Board, the Secretary of Agriculture, the Farm Credit Administration, the Securities and Exchange Commission, the Small Business Administration and the Secretary of Transportation.

**ECOA in action**

What are these required actions and how do they apply to you? ECOA spells out required actions in three areas. Each area of action protects consumers from discriminatory practices and allows mortgage originators to help their borrowers while observing the highest level of ethics.

Let's start with actions related to inquiries for credit. You can read § 1002.5 for the rules concerning requests for information.[2] These required actions state that:

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[1] EQUAL CREDIT OPPORTUNITY ACT (REGULATION B) CFR Part 12 § 1002.1
[2] EQUAL CREDIT OPPORTUNITY ACT (REGULATION B) CFR Part 12 § 1002.5 (a)-(e)

- You **MAY NOT** discriminate against an applicant on a prohibited basis (being in a protected class)
- You **MAY NOT** discourage someone from making an application verbally or in writing, including advertisements, on a prohibited basis
- You **MUST** take a written application for dwelling-related credit

**Disclosures:**

If you issue written disclosures, you **MUST** provide them in a clear and conspicuous manner.

If your disclosures are issued electronically, they are subject to compliance with the consumer consent and other applicable provisions of the Electronic Signatures in Global and National Commerce Act (E-Sign Act) (15 U.S.C. 7001 et seq).

If you issue disclosures in a foreign language, the disclosures must also be available in English.[1] In addition:

- You **MAY** request any information necessary to make a credit decision as long as the information complies with Federal and State Laws
- You **MAY NOT** *inquire about a borrower's* race, color, religion, national origin, or sex, unless you are requesting information for monitoring purposes

  You **MAY NOT** request **any** information concerning the spouse or former spouse of an applicant unless:
  - The spouse will be permitted to use the account
  - The spouse will be contractually liable on the account
  - The applicant is relying on the spouse's income as a basis for repayment of the credit requested
  - The applicant resides in a community property state or is relying on property located in such a state as a basis for repayment of the credit requested
  - The applicant is relying on alimony, child support, or separate maintenance payments from a spouse or former spouse as a basis for repayment of the credit requested

  If an application is for secured credit, such as a mortgage loan, you **MAY** inquire about the applicant's marital status, but only use the terms 'married', 'unmarried', and 'separated.'

[1] EQUAL CREDIT OPPORTUNITY ACT (REGULATION B) CFR 12 Part § 1002.4 (a)-(e) General rules

However, you may wish to state that the category 'unmarried' refers to single, divorced, or widowed persons

You ***MAY NOT*** ask whether the income stated in an application is derived from alimony, child support, or separate maintenance payments ***UNLESS*** you disclose to the borrower such income needs not be revealed if the borrower does not want the lender to consider it in determining their creditworthiness

You ***MAY NOT*** ask any questions regarding childbearing or child rearing

> ***Remember:***
>
> ***For a mortgage loan you MAY only inquire about the marital status using the terms:***
>
> ***Married,***
>
> ***Unmarried (including Single, Divorced, Widowed),***

After you have taken a complete application, you want to be sure that the borrower is being evaluated without any consideration of their *"race, color, religion, national origin, sex, marital status, or age (provided the applicant has the capacity to contract); to the fact that all or part of the applicant's income derives from a public assistance program; or to the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act."*

Next, let's review actions related to the evaluation of applications. You can read the text of ECOA at *§ 1002.6 Rules concerning evaluation of applications*[1]. Now that you have taken an application for credit according to ECOA, you want to know how to evaluate that application in a non-discriminatory manner.

Generally a lender can consider any information obtained, as long as the information is not used to discriminate against an applicant. However:

- You **MAY NOT** take a prohibited basis (being in a protected class) into account in any system of evaluating the creditworthiness of applicants.

[1] EQUAL CREDIT OPPORTUNITY ACT (REGULATION B) CFR 12 Part § 1002.6 Rules concerning evaluation of applications.

- The Equal Credit Opportunity Act protects borrowers who are on public assistance. Therefore you **MAY NOT** refuse to consider income derived from any public assistance program. Keep in mind it is the stability and amount of the income that matters, not the source of the income.
- You **MUST** consider stable income from any public assistance program in the same way as any other income.
- You **MAY NOT** take into account an applicant's age (provided that the applicant has the capacity to enter into a binding contract).
- You **MAY NOT** make assumptions or use aggregate statistics relating to the likelihood that any category of persons will bear or rear children or will, for that reason, receive diminished or interrupted income in the future.
- You **MAY NOT** take into account whether there is a telephone listing in the name of an applicant.
- You **MAY NOT** discount or exclude from consideration the income of an applicant or that of the spouse of an applicant because they are in a protected class or because their income is derived from part-time employment or is an annuity, pension, or any other retirement benefits. However, you **MAY** consider the amount and probable continuance of the income to determine creditworthiness.
- When an applicant relies on alimony, child support, or separate maintenance payments in applying for credit, you **MUST** consider such payments as income to the extent that they are likely to be consistently made.
- You **MAY** consider the applicant's immigration status or status as a permanent resident of the United States.
- You **MUST** evaluate married and unmarried applicants by the same standards and you **MAY NOT** treat applicants differently based on the existence, absence, or likelihood of a marital relationship between the parties.

***When a borrower receives reliable alimony, child support or separate maintenance, they are not required to disclose such income. You may not discriminate against someone who exercises their good faith rights of non-disclosure.***

- You **MAY NOT** consider race, color, religion, national origin, or sex (or an applicant's or other person's decision not to provide the information) in any aspect of a credit transaction.

After you take a complete application and have evaluated the information for approval, you must then inform the borrower of any adverse or alternative action you have taken on their request. It makes good sense to keep any borrower up to date on the processing of their application. The required actions are listed in § 1002.9 Notifications (a) Notification of action taken:

*(a) Notification of action taken, ECOA notice, and statement of specific reasons — (1) When notification is required. A creditor shall notify an applicant of action taken within:*

*(i) 30 days after receiving a completed application concerning the creditor's approval of, counteroffer to, or adverse action on the application;*
*(ii) 30 days after taking adverse action on an incomplete application, unless notice is provided in accordance with paragraph (c) of this section;*
*(iii) 30 days after taking adverse action on an existing account; or*
*(iv) 90 days after notifying the applicant of a counteroffer if the applicant does not expressly accept or use the credit offered."*[1]

**A LENDER IS REQUIRED TO NOTIFY THE APPLICANT OF THEIR LENDING DECISION WITHIN 30 DAYS OF TAKING A COMPLETE APPLICATION**

Written notification of adverse action must disclose at minimum:

- Applicant name, address and type of loan applied for
- Description of action taken (denial, less favorable terms, incomplete application)
- More specific reasons for denial or adverse action

If a credit report was used to make a credit decision, you must also include the following information:

- This statement: *Our credit decision was based in whole or in part on information obtained in a report from the consumer reporting agency listed below. You have a right under the Fair*

[1] EQUAL CREDIT OPPORTUNITY ACT (REGULATION B) CFR 12 Part § 1002.9 Notifications

*Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency.*

- Numerical credit score used
- The key factors that adversely affected the consumer's credit score
- The date the credit score was created and the entity that provided the score

If the decision was made from a source other than a consumer reporting agency, the following statement should also be included:

*The applicant has to make a written request, no later than 60 days after you receive this notice to get a list of specific reasons for adverse action taken.*

## Home Mortgage Disclosure Act (HMDA) Regulation C

The Home Mortgage Disclosure Act requires most mortgage lenders that have offices or branches in metropolitan areas to collect data about their housing-related lending activity. HMDA does not prohibit lending activity nor encourage unsound lending practices. The Federal Financial Institutions Examination Council (FFIEC) prepares a disclosure statement from the data each financial institution submits every single year.

Who must report? Most financial institutions including depository banks, savings associations, and credit unions with assets of $42 million or more as of December 31, 2012. Any other lender including mortgage lenders and non-depository banks that have a branch in a Metropolitan Statistical Area (MSA) and had assets exceeding $10 million on the preceding December 31, or originated 100 or more home purchase loans (including refinancing of home purchase loans) in the preceding calendar year.

The data reported is public information and is used to:

- Assess whether financial institutions are meeting the needs of their communities
- Identify possible discriminatory lending patterns and enforce antidiscrimination statutes
- Help public officials in distributing public-sector investment so as to attract private investment to areas where it is needed

Information on home purchase loans, home improvement loans and refinances are reported each March 1. The data reported includes the following items:

*(1) An identifying number for the loan or loan application, and the date the application was received.*

*(2) The type of loan or application.*

*(3) The purpose of the loan or application.*

*(4) Whether the application is a request for preapproval and whether it resulted in a denial or in an origination.*

*(5) The property type to which the loan or application relates.*

*(6) The owner-occupancy status of the property to which the loan or application relates.*

*(7) The amount of the loan or the amount applied for.*

*(8) The type of action taken, and the date.*

*(9) The location of the property to which the loan or application relates.*

*(10) The ethnicity, race, and sex of the applicant or borrower, and the gross annual income relied on in processing the application.*

*(11) The type of entity purchasing a loan.*

*(12) The difference between the loan's annual percentage rate (APR) and the average prime offer rate for a comparable transaction as of the date the interest rate is set, if that difference is equal to or greater than 1.5 percentage points for loans secured by a first lien on a dwelling, or equal to or greater than 3.5 percentage points for loans secured by a subordinate lien on a dwelling.*

*(13) Whether the loan is subject to the Home Ownership and Equity Protection Act.*

*(14) The lien status of the loan or application (first lien, subordinate lien, or not secured by a lien on a dwelling).*

*<u>Optional data. A financial institution may report</u>:*

*(1) The reasons it denied a loan application;*

*(2) Requests for preapproval that are approved by the institution but not accepted by the applicant; and*

*(3) Home-equity lines of credit made in whole or in part for the purpose of home improvement or home purchase.*[1]

# D. Disparate Impact and Mortgage Lending

The Consumer Financial Protection Bureau, HUD and other federal agencies take discrimination seriously. Discrimination is treating some people less fairly than others because of their race, color, national origin, religion, sex, familial status, religion, marital status, or age. Because mortgage lenders are required to comply with both ECOA and FACTA, you must be sure to comply with the required actions of both acts.

One specific type of discrimination is known as 'disparate impact.' Disparate impact focuses not on discriminatory intent, but instead on discriminatory consequences. A disparate impact occurs when a lender applies a facially-neutral pattern of practice equally to all credit applicants but the policy or practice disproportionately excludes or burdens certain persons on a prohibited basis. Without nondiscriminatory access to credit, consumers face obstacles in obtaining equal access to housing.

An example would be a lender that does not make mortgage loans below $100,000. Although there are strong business reasons why these loans are not good for their business model, this minimum loan amount may have a disparate impact on minorities or others who may be excluded because of their income or factors such as home values in their area.

Richard Cordray, the Consumer Financial Protection Bureau's director, made this statement *"We want consumers to avoid the marketplace's silent pickpocket—discrimination. We cannot afford to tolerate practices, intentional or not, that unlawfully price out or cut off segments of the population from the credit markets. That's why the CFPB is educating consumers about their fair-lending rights and pursuing lenders whose practices are discriminatory."*[2]

*HUD has created a final rule regarding the Implementation of the Fair Housing Act's Discriminatory Effects Standard*[3]. *This rule says that* the Fair Housing Act may be violated by a

1 HOME MORTGAGE DISCLOSURE (REGULATION C) CFR 12 Part § 1003.4 (1)-(14) Compilation of loan data.

2 http://www.consumerfinance.gov/pressreleases/the-cfpb-issues-civil-penalty-fund-rule/

3 Department of Housing and Urban Development 24 CFR Part 100
Implementation of the Fair Housing Act's Discriminatory Effects Standard;
Final Rule

practice that has a discriminatory effect, regardless of whether the practice was adopted for a discriminatory purpose. *"A practice has a discriminatory effect where it actually or predictably results in a disparate impact on a group of persons or creates, increases, reinforces, or perpetuates segregated housing patterns because of race, color, religion, sex, handicap, familial status, or national origin*."

This final rule adds a new subpart G, entitled "Discriminatory Effect". *Section 100.500(a) provides that a "discriminatory effect" occurs where a facially neutral practice actually or predictably results in a discriminatory effect on a group of persons protected by the Act (that is, has a disparate impact), or on the community as a whole on the basis of a protected characteristic (perpetuation of segregation). Any facially neutral action, e.g., laws, rules, decisions, standards, policies, practices, or procedures, including those that allow for discretion or the use of subjective criteria, may result in a discriminatory effect actionable under the Fair Housing Act and this rule. "*[1]

*You can see that it is important to know how to act in a fair and equitable manner in all transactions and towards all borrowers equally. We will learn more about predatory lending practices and loans in the next chapter.*

[1] Department of Housing and Urban Development 24 CFR Part 100
Implementation of the Fair Housing Act's Discriminatory Effects Standard;
Final Rule *Section 100.500(a)*

# More on HOEPA and Predatory Lending[1]

## A. Overview

In 1994, amidst the rapid growth of subprime lending, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to help curb predatory lending. HOEPA was designed as an amendment to the Truth in Lending Act (TILA). Many significant further amendments of HOEPA have been introduced since. Most of the amendments were aimed at preventing the exploitation of borrowers due to predatory lending practices. HOEPA defines a specific class of loans that it covers, mainly based on the amount of the APR and fees. The rule-making authority for HOEPA and TILA was transferred to the Consumer Financial Protection Bureau effective July 21, 2011. As a Mortgage Originator, you are responsible to know the current law, what is proposed and when the new rules will take effect. You can find all regulations on the Consumer Protection Finance Bureau website here: http://www.consumerfinance.gov/regulations/. Much of the increase in mortgage lending to previously underserved populations can be attributed to the development of the subprime mortgage market. This rapid growth gave consumers access to credit for the very first time, for instance because they had, until then, been unable to meet the underwriting criteria of prime lenders.

However, the rise in lending to lower-income homeowners has not come without cost and has been accompanied by increasing reports of abusive, unethical, and, in some cases, illegal practices. Such lending practices jeopardize the twin American dreams of owning a home and building wealth.

Victims of predatory lending are liable to lose hard-earned equity in their homes and may even be faced with foreclosure. Some people call predatory lending 'redlining in reverse.' Whereas redlining refers to the practice in which lenders avoid lending to certain segments of the population based on race, gender or other attributes, predatory lending refers to the opposite -

[1] Source: Home Ownership and Equity Protection Act (Amendment to the Truth in Lending Act Regulation Z) CFPB Section 12 CFR 1026

excessive unethical lending to a previously underserved population or borrowers who do not meet general credit underwriting criteria.

HOEPA is one of the most recent laws that address discriminatory practices in mortgage lending. The intentional targeting of borrowers in underserved or poor areas with expensive high-cost loans is a practice known as reverse redlining and is illegal under HOEPA
Although HOEPA does not prevent charging excessive fees or a high interest rate, it places limitations on the terms that can be offered if the loan meets or exceeds a threshold for APR or fees and requires additional disclosures. These loans are also called 'section 32 loans' and are named after the Regulation Section that covers the rules.[1] Currently, HOEPA rules do not apply to purchase money loans.

A loan is covered under HOEPA if it meets any of the following tests:

- For a first-lien mortgage, the APR exceeds by more than 8% the rates on Treasury securities of comparable maturity
- For a second subordinate lien mortgage, the APR exceeds by more than 10% the rates on Treasury securities of comparable maturity
- For 2013, the total fees or points payable by the consumer at or before closing exceeds the larger of $625 or 8% of the total loan amount. The amount and percentage is adjusted annually by the Federal Reserve Board, based on changes in the Consumer Price Index, or CPI.

On January 10, 2014 the types of mortgage loans that are covered under HOEPA will expand to these thresholds:

*Where the annual percentage rate applicable to the transaction will exceed the average prime offer rate for a comparable transaction by more than:*

- 6.5 percentage points for a first-lien transaction
- 8.5 percentage points for a first-lien transaction if the dwelling is personal property and the loan amount is less than $50,000 *or*
- 8.5 percentage points for a subordinate-lien transaction

*Where the transaction's total points and fees will exceed:*

- 5 percent of the total loan amount for a transaction with a loan amount of $20,000 or more

[1] Home Ownership and Equity Protection Act High Cost Loans (Amendment to TILA Regulation Z) CFPB Section 12 CFR 1026.32

- The lesser of 8 percent of the total loan amount or $1,000 with a loan amount of less than $20,000

Note: the following transactions are exempt:
- A reverse mortgage transaction
- A transaction to finance the initial construction of a dwelling
- A transaction originated by a Housing Finance Agency, where the Housing Finance Agency is the creditor for the transaction
- A transaction originated pursuant to the United States Department of Agriculture's Rural Development Section 502 Direct Loan Program[1]

# B. Examples of Predatory Lending Activities

HOEPA aims to limit the subset of lending practices that are unethical, abusive and illegal. Some predatory lending involves outright fraud and deception, both of which are already unlawful. However, some predatory lending is more subtle, involving the misuse of conventions which, in the majority of cases, can be beneficial. We'll briefly discuss several examples.

Prohibited Activities

- Lending based on equity instead of the borrower's ability to repay: a borrower's ability to repay must be verified with appropriate income, assets and must take into consideration other mortgage-related obligations
- Refinancing one HOEPA loan into another HOEPA loan within a one-year period
- Direct payments to home improvement contractors: certain restrictions are in place to protect homeowners who close a home-improvement loan so that payments must be authorized by the borrower if these will be made directly to the contractor
- Evading HOEPA by documenting loan as open-ended: lenders cannot structure a loan as open-ended to evade HOEPA guidelines
- Negative amortization
- Increased interest rate after default
- Advanced payments: creditors may only finance in 2 periodic payments to a HOEPA loan
- Selling the loan without labeling it as HOEPA
- Due-on demand clauses
- Balloon payments (none for loans with terms of less than 5 years)
- Prepayment penalties (none allowed after the first 2 years)

[1] Regulation Z, 12 CFR Part §1026.32(a)(a)(2)

- 
- On January 10, 2014 the following prohibition will also apply:
- Closing a HOEPA loan without receiving a certification of Homebuyer counseling: lenders must receive proof that the borrower has obtained counseling on the advisability of the mortgage from a counselor that is approved by HUD or, if permitted by the Secretary, by a State housing finance authority[1]

1. **Asset-Based Lending**. Extending credit to borrowers unable to repay the debt is called asset-based lending. This problem is exacerbated by lenders who do not verify income. In such a case, once a borrower fails to make payments, the lender would foreclose on the property, thus obtaining the property as their asset.

2. **Loan Flipping**. This involves repeatedly refinancing, or "flipping," loans for the purpose of repeatedly collecting fees from homeowners.

3. **Excessive Fees**. Incorporating credit terms and products that are of questionable value to the borrower but that significantly increase the cost of credit.

4. **Making unaffordable loans**. Establishing high loan-rate adjustments to a loan without careful consideration of the potential impact on the consumer. Sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. Sometimes the loans have high prepayment penalties so that the borrowers are trapped, and have to continue paying high interest rates.

5. **Exploiting the elderly**. Offering elderly homeowners a home equity loan even though they could qualify for a reverse mortgage due to the large amount of equity that has built up in their home. Another example is advising borrowers to draw money using a reverse mortgage and then offering to use the money for investments or home improvements or to buy other insurance products.

6. **Exploiting people’s ignorance**. Targeting groups of people who lack knowledge of the mortgage process and market. Groups that have disproportionately been preyed upon by unscrupulous creditors are women, minorities, and lower-income households.

7. **Dishonest servicer practices**. Failing to credit a payment to a consumer’s account when the servicer receives it or failing to provide a payoff statement within a reasonable period of time. Also, “pyramiding” late fees, which means the servicer continues to charge certain late

[1] TRUTH IN LENDING (REGULATION Z) 12 CFR Part § 1026.34(5)(i)(ii) Prohibited acts or practices in connection with high-cost mortgages

fees until all prior late fees have been paid, as opposed to just levying a charge on the original late payments.

8. **Inflated appraisals**. Coercing or encouraging an appraiser to misrepresent the value of a home. This practice may include informing an appraiser of the minimum reported value needed to approve the loan, conditioning an appraiser's compensation on the closure of a loan or suggesting that the appraiser will be excluded from future transactions.

9. **Excessive yield spread premiums (kickbacks to brokers)**. Deliberately quoting lower yield spread premiums than those the broker is willing to honor. This practice is sometimes referred to as 'Mortgage Price Low-Balling.'

10. **Misleading Advertisements**. Propagating misleading or deceptive advertising for closed-end loans.

11. **Advance Fee Schemes**. Charging would-be borrowers upfront fees for services the promoter has no intention of providing.

# C. HOEPA Protections

HOEPA designates protections specific to various mortgage types it defines by the level of the APR; however, many of these protections are the same for each defined mortgage type. Though HOEPA defines further protections for specific high-interest and high-fee classes of loans, the following apply to all loans secured by a consumer's principal dwelling, regardless of the loan's APR:

**Lender Credit Limits:** Prohibits lenders from paying the broker's portion of the lender credit to anyone other than the borrower. The premium, if any, must be shown as a credit to the borrower.

**Servicer limitations:** Prohibits certain servicing practices, such as failing to credit a payment to a consumer's account when the servicer receives it, failing to provide a payoff statement within a reasonable period of time, and "pyramiding" late fees. As a note, HELOCs are excluded from this regulation.

**Appraisal limitations:** Prohibits a creditor or broker from coercing or encouraging an appraiser to misrepresent the value of a home. Importantly, this rule specifies not informing the appraiser of the minimum reported value needed to approve the loan, not conditioning the appraiser's compensation on the closing of the loan and not suggesting to the appraiser that they may be excluded from future transactions based on their appraisal.

**Further Advertising Limits:** Prohibits misleading or deceptive advertising practices, for example, using the term 'fixed' to describe a rate that is not truly fixed. This also requires that all applicable rates or payments be disclosed in advertisements with the same prominence as the advertised introductory or 'teaser' rates.

**Late Disclosure:** These rules require the distribution of truth-in-lending disclosures to borrowers early enough for borrowers to shop for a mortgage. Under HOEPA, creditors would have to provide a good faith estimate of the loan costs, including a schedule of payments, within three business days after a consumer applies for any mortgage loan secured by a consumer's principal dwelling, such as a home improvement loan or a loan to refinance an existing loan. Before HOEPA, early cost estimates were only required for home-purchase loans. In addition, HOEPA now provides that consumers cannot be charged any fee until after the consumer receives the disclosures, except a reasonable fee for obtaining the consumer's credit history.

# D. Disclosures

Disclosures under HOEPA include:

- A written notice that the loan need not be completed, even though the borrower has signed the loan application and received the required disclosures. The borrower must have at least 3 business days prior to the scheduled closing to decide whether to sign the loan agreement after receiving the special Section 32 disclosures.
  - The notice must warn the borrower that they could lose their home and any money put into it if they fail to make payments.
- Disclosure by the lender of the APR, the regular payment amount (including any balloon payment where the law permits balloon payments), and the loan amount (when the amount borrowed includes credit insurance premiums, that fact must also be stated). In the case of ARMs, the lender must disclose that the rate and monthly payment may increase and state the amount of the maximum monthly payment amount. The lender must also specify that there is no guarantee the consumer will be able to refinance the transaction to lower the interest rate or periodic payments. For a mortgage refinancing, the total amount the consumer will borrow, as reflected by the face amount of the note, the disclosure of the amount borrowed shall be treated as accurate if it is not more than $100 above or below the amount required to be disclosed.

# E. Higher-Priced Loans / Section 35[1]

TILA Section 1026.35 protects consumers from abusive and predatory lending practices by imposing prohibited acts and practices on certain higher-priced loans. Section 35 loans are described as: "

*§ 1026.35 (a) Definitions. For purposes of this section: (1)Higher-priced mortgage loan means a closed-end consumer credit transaction secured by the consumer's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set:*

*(i) By 1.5 or more percentage points for loans secured by a first lien with a principal obligation at consummation that does not exceed the limit in effect as of the date the transaction's interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac;*

*(ii) By 2.5 or more percentage points for loans secured by a first lien with a principal obligation at consummation that exceeds the limit in effect as of the date the transaction's interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac; or*

*(iii) By 3.5 or more percentage points for loans secured by a subordinate lien."*[2]

The APR for Higher-Priced loans is compared to the Average Prime Offer Rate. You can look up the APOR here: www.ffiec.gov/ratespread/newcalc.aspx .

Section 35 Higher-priced loans requirements:

- The creditor must verify the borrower's ability to re-pay the loan
- Prepayment penalties are generally limited to the first 2 years
- Appraisals are required including an internal inspection of the property
- The creditor must establish an escrow account for taxes and insurance for at least five (5) years

[1] TRUTH IN LENDING (REGULATION Z) **CFR 12 Part §1026.35** Prohibited acts or practices in connection with higher-priced mortgage loans

[2] 12 CFR--PART 1026.35 AMENDMENTS: EFFECTIVE DATES: June 1, 2013

- A closed-end loan cannot be structured as an open-ended loan to evade the requirements

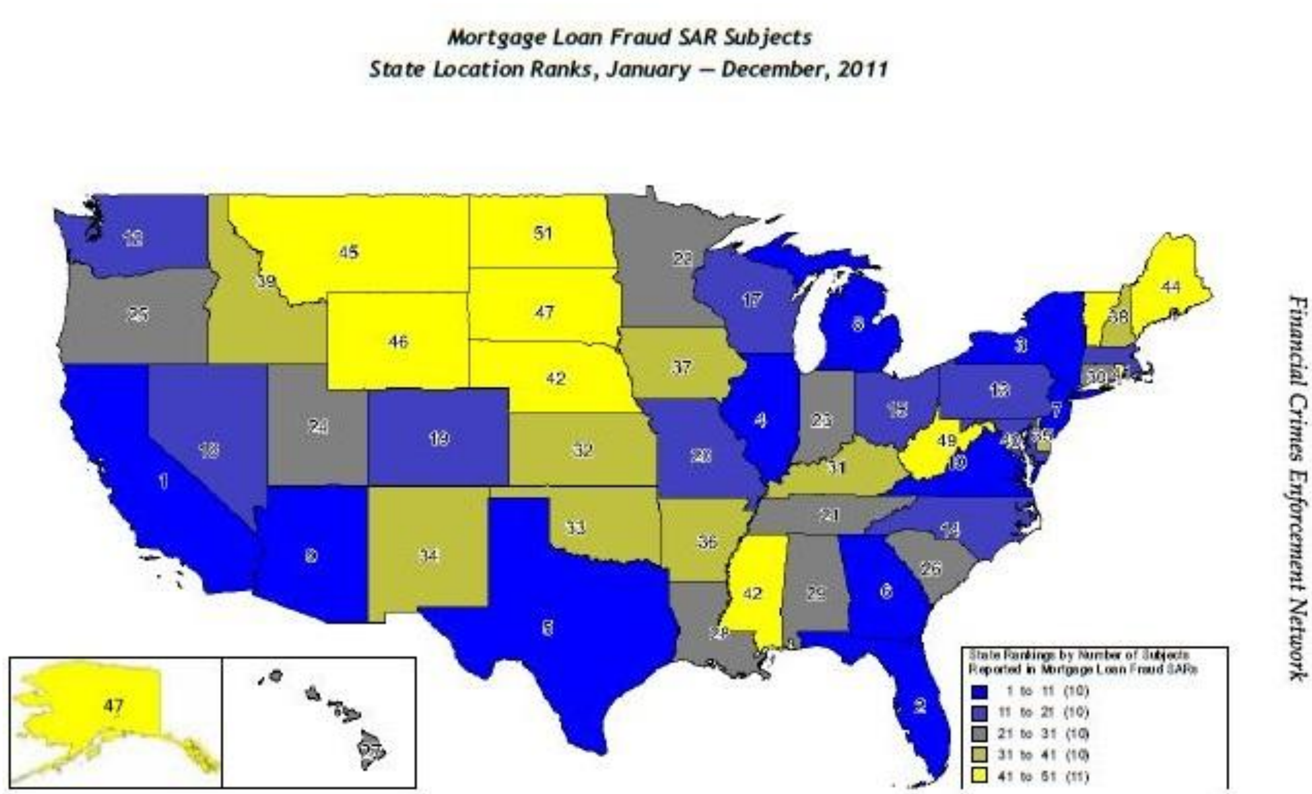
- The following transactions are exempt from the appraisal and escrow requirements:
- A reverse mortgage transaction
- A transaction to finance the initial construction of a dwelling
- A transaction originated by a Housing Finance Agency, where the Housing Finance Agency is the creditor for the transaction
- A transaction originated pursuant to the United States Department of Agriculture's Rural Development Section 502 Direct Loan Program[1]

[1] Regulation Z, 12 CFR Part §1026.32(a)(a)(2)

# Mortgage Fraud

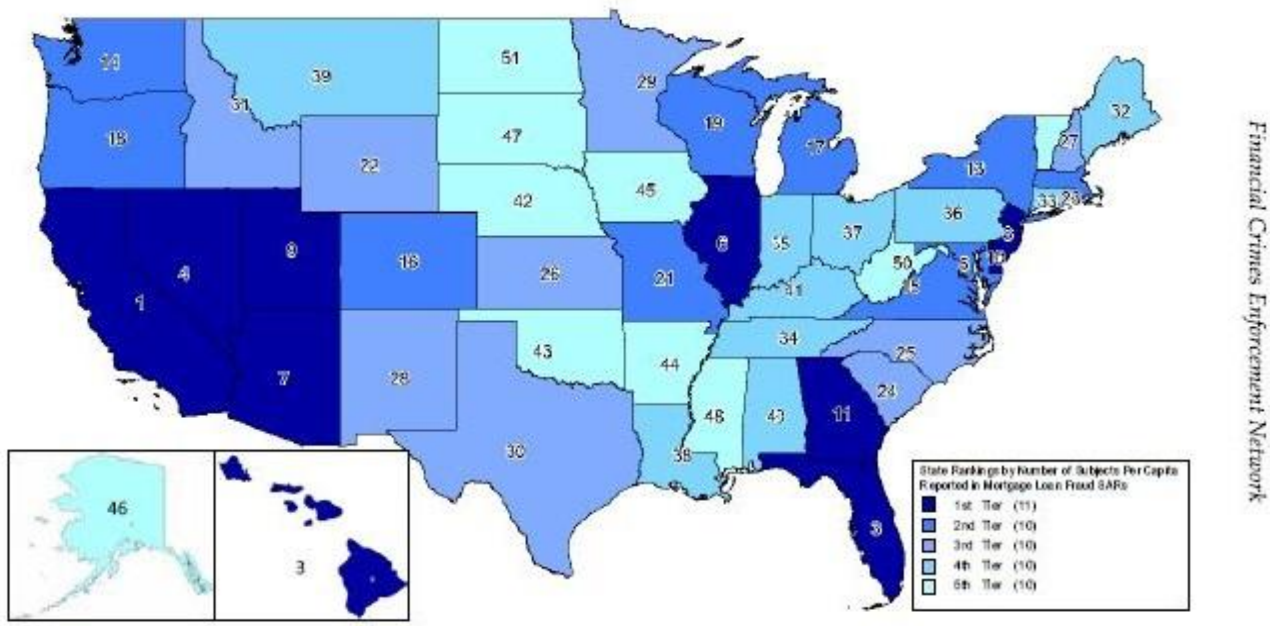
## A. Overview

Mortgage fraud is pervasive throughout the United States. The main enforcer of fraud cases is the FBI's National Mortgage Fraud Team Financial Institution Fraud Unit. . The other regulator for mortgage fraud is the Financial Crimes and Enforcement Network (FinCEN), which is a branch of the Department of the Treasury. The role of FinCEN is as follows: "***FinCEN's mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities."[1] Their most recent reports show just how wide-spread the problem is***




[1] http://www.fincen.gov/ Figure 1: FinCEN Report of Mortgage Fraud SARs Reports for 2012.

*Mortgage Loan Fraud SAR Subjects Per Capita*
*State Location Ranks, January — December, 2011*




At this time, the mortgage industry itself does not provide estimates on total industry fraud. Still, according to various industry reports as well as FBI and FinCEN analysis, mortgage fraud is pervasive and growing. A recent analysis of mortgage industry fraud surveys identified 26 different states as having significant mortgage fraud problems

## B. General Fraud Focus

The FBI and FinCEN investigate mortgage fraud in two distinct areas: Fraud for Profit and Fraud for Housing. Fraud for Profit is sometimes referred to as 'Industry Insider Fraud' and the motive is to revolve equity, falsely inflate the value of the property, or issue loans based on fictitious properties. In their 2011 report, FinCEN noted that " Mortgage fraud schemes are particularly resilient, and they readily adapt to economic changes and modifications in lending practices. "

Mortgage fraud perpetrators include licensed/registered and non-licensed/registered mortgage brokers, lenders, appraisers, underwriters, accountants, real estate agents, settlement attorneys, land developers, investors, builders, bank account representatives, and trust account representatives.

Fraud for Housing represents illegal actions perpetrated by the borrower. The simple motive behind this fraud is to acquire and maintain ownership of a house under false pretenses. This type of fraud is typified by a borrower who makes misrepresentations regarding his or her income or employment history to qualify for a mortgage loan. However, this type of fraud also often involves some participation from industry insiders, even if only to 'look the other way.'

Although there are many mortgage fraud schemes, FinCEN is focusing its efforts on those perpetrated by industry insiders.

# C. Common Fraud Schemes

The following is a list of common mortgage fraud schemes, most of which include some types of basic criminal acts. Though many types of fraud involve multiple schemes, we have included relevant examples that focus on the specific scheme we are discussing.

- Submitting false information on documents (income, payment history, employment history, etc…)
- Submitting false documentation (VORs, VOEs, appraisals, credit reports, etc..)
- Forging signatures on documents (sales agreements, loan applications, etc..)
- Receiving monies intended for someone else
- Mail fraud
- Wire fraud

We have included the source of the information and a link to the relevant website below the example.

**Nominee Loans/Straw Buyers**: The identity of the borrower is concealed through the use of a nominee who allows the borrower to use the nominee's name and credit history to apply for a loan. Straw buyers are a common element to the vast majority of fraud schemes. The following article illustrates the role played by Straw Buyers.

***Example:*** *When most people buy a home they are required to submit financial paperwork to banks, title companies, and others involved in the mortgage process. The case of the "House King" in South Florida illustrates how, when fraudsters manipulate that system, lenders can lose millions—and innocent buyers and sellers also suffer*.

The House Angel, Angel Puentes, used a classic loan origination scam, said Stemen, a veteran mortgage fraud investigator in our Miami office. "In this scheme, you had all the players," she explained, from straw buyers—who are paid to lend their name to documents—to a real estate agent, licensed mortgage broker, and title attorney. Mortgage applications were falsified to inflate the value of properties, defraud lenders, and line the pockets of the fraudsters.

Puentes—also known as D'Angelo Salvatore—was so influential he created his own glossy real estate magazine called *House King*. "Five or six years ago, he was the guru of South Florida real estate," said Special Agent Mark Soucy, who investigated the case, adding that "100 percent of the funding for the magazine came from the fraud he was committing."

**The House King paid straw buyers to sign bogus mortgage applications claiming that purchased homes would be their primary residences—when in reality, they had no intention of living there.** The fraud was so extensive that some buyers had closings with three different lenders on the same day.

An attorney signed off on the fake documents, and the lenders—believing everything was legitimate—made the loans. The applications also inflated the value of the properties. If a home was appraised at $400,000, for example, the bogus loan application might list the value at $500,000. Puentes pocketed the extra money and used it to pay his accomplices. He then paid the mortgage for a number of months, until he could flip the property for a further profit—or sometimes he rented it out to generate more income. But then he stopped paying. After taking his ill-gotten profit, Puentes simply walked away from the mortgage, leaving the lender with a toxic asset. Meanwhile, he was living large, taking trips to Paris and buying a Ferrari.

We began investigating Puentes in 2008. At the time, before the real estate market began to collapse in South Florida and around the country, many speculators were buying properties and trying to flip them for quick profits. But Stemen said, "Our investigation focused on the organized group that was falsifying documents to profit from the loan origination schemes."

**Puentes was indicted in February 2011 on multiple counts of wire and bank fraud and for defrauding three lending institutions out of approximately $10.5 million.** Although he fled the country for a time, Puentes eventually returned and was arrested. In June 2011, he was sentenced to more than eight years in prison.
Because of fraudsters such as Puentes, South Florida real estate was artificially inflated and innocent people paid too much for their homes. When the market crashed, many of

those homeowners were left underwater—their property worth less than what they paid for it.

"Those are the true victims of this type of mortgage fraud," Soucy said—"the legitimate South Florida residents whose home values were inflated because of these fraudulent transactions."[1]

**Fictitious/Stolen Identity:** A fictitious/stolen identity is used on the loan application. The applicant may be involved in an identity-theft scheme: an individual's name, personal identifying information and credit history are used without the true person's knowledge.

***Example, Amerifunding Investigation***: Stolen identities were obtained by placing "help wanted" advertisements. Job applicants would submit significant amount of information and then the application information was used to create fraudulent identities based on the stolen information from the applicants.

AMERIFUNDING (Denver): This joint investigation with IRS/CID involved kiting of mortgage loans by utilizing stolen identities to facilitate the scheme. Further investigation determined that the scheme involved over $200 million in fraudulent loans over a 24 month period. *One of the subjects obtained fraudulent identities by placing "help wanted" advertisements in a local newspaper. Information from the victims applications were used to apply for mortgage loans between $300,000 and $500,000*. The proceeds of the scheme were used to pay personal expenses of the defendants.

Federal Bureau of Investigation, *"Operation Quick Flip,"* December 14, 2005 **http://www.fbi.gov/page2/dec05/operationquickflip121405.htm**

**Property Flipping:** A property is purchased, falsely appraised at a higher value, and then quickly sold. A home may also be superficially improved, although no real value is added, and then sold for an inflated price. The schemes typically involve one or more of the following: fraudulent appraisals, doctored loan documentation, inflated buyer income. Kickbacks to buyers, investors, property/loan brokers, appraisers, and title company employees are commonly used in property flipping. For instance, a home worth $50,000 may be appraised for $100,000 or higher in this type of scheme. This is a classic example of a flipping scheme. Homebuyers are harmed by this tactic as they purchase a home that is not worth as much as they paid for it. Lenders are harmed by this because they have made a loan based on an inflated appraisal and a higher LTV than would have been the case had they been in possession of accurate information.

[1] http://www.fbi.gov/news/stories/2012/august/mortgage-fraud-king-a-royal-con-man

***Example, Indictment by Federal Grand Jury in Seattle***: The perpetrators included a group of six, including a lawyer, a former bank loan officer, a mortgage broker and three owners of shell companies, including a construction company and an 'escrow' company. The perpetrators would purchase properties through shell companies. They then recruited straw buyers who would purchase the homes at a higher price. They would pay straw buyers some part of the profit as the buyer would default on loans and allow foreclosure.

"Six people were indicted by a Federal Grand Jury in Seattle yesterday for Conspiracy and Wire Fraud in connection with an estimated $8.5 million mortgage fraud scheme conducted in 2004 and 2005. Those indicted include a lawyer (since disbarred), a former bank loan officer and a mortgage broker, as well as the owner of shell companies involved in "flipping" dozens of properties as part of the fraud. Some of the defendants will make their initial appearances in U.S. District Court in Seattle at 2:30 today, including ROBERT ERNEST BRANDT, 40, the attorney who funneled money in the scheme through his client trust account.

According to the indictment returned in the Western District of Washington, BRANDT and WILLIAM ANDERSON, 47, of Bellevue, conspired with MUSTAFA "MARC" KHOSRAW, 46, of Sammamish, ISAAC PALMER, 42, of North Bend, KRISTYN JUPITER MOSS, 38, of Tacoma and ZACHARY JOSEPH NAMIE, 30, of Seattle, to defraud banks and other financial institutions using a mortgage fraud scheme. *The conspirators would identify houses and would use shell companies or third parties to purchase the homes. At the same time they recruited "straw buyers" who would enter into a purchase agreement to buy the same home from the conspirators at an inflated price (a "flip").* The conspirators assisted the straw buyers with phony paperwork for the home loans, making it appear that they were qualified for the mortgage loans and planned to occupy the houses. Members of the conspiracy allegedly falsified numerous documents including appraisals, verifications of deposits, employment verification and closing documents. In fact, the conspirators simply split the proceeds from the fraudulent mortgages, and the *straw buyers defaulted on the loans after pocketing as much as $20,000 for their fee. The homes were foreclosed and financial institutions and mortgage lenders suffered substantial losses.*

The defendants served various roles in the scheme. ANDERSON operated SFN, LLC, and Sterling Investments -- shell companies that initially purchased numerous properties. ANDERSON and MOSS, then a loan officer for Viking Bank, allegedly created many of the false documents. BRANDT and ANDERSON jointly ran a company called "Escrow Authority," that closed the sales of the properties. KHOSRAW, a mortgage broker, and NAMIE, a loan officer with a mortgage company, allegedly created and submitted some of the false documents. PALMER operated a construction company called GMI Construction, and allegedly recruited straw buyers and falsely claimed that some of them worked for him."

Department of Justice, Seattle Press Releases, "*Six Indicted For Mortgage Fraud In Operation 'Malicious Mortgage' - Lawyer, Mortgage Broker and Others Conspire in $8.5 million Fraud, 'Flipping' Dozens of House,"* June 19, 2008

**http://seattle.fbi.gov/dojpressrel/2008/pr061908b.htm**

**Inflated Appraisals:** An appraiser acts in collusion with a borrower and/or MLO and provides a misleading appraisal report to the lender. The report inaccurately states an inflated property value and is a common feature of most flipping schemes.

***Example,*** BALTIMORE—April 19, 2013 U.S. District Judge James K. Bredar sentenced real estate appraiser David C. Christian, age 63, of Catonsville, Maryland today, to 15 months in prison, followed by three years of supervised release, for conspiracy to commit wire fraud. Judge Bredar also ordered Christian to pay restitution of $2,440,804.

The sentence was announced by United States Attorney for the District of Maryland Rod J. Rosenstein; Special Agent in Charge Stephen E. Vogt of the Federal Bureau of Investigation; Inspector General Steve A. Linick of the Federal Housing Finance Agency; and Postal Inspector in Charge Gary R. Barksdale of the U.S. Postal Inspection Service-Washington Division.

According to his guilty plea, Christian appraised a number of properties on behalf of purchasers who were seeking financing through Worthington Mortgage Group LLC, a mortgage brokerage company controlled by Joshua Goldberg, operating out of an office on Gough Street in Baltimore. Christian admitted that from April 2004 to April 2008, at Goldberg's request, he prepared at least 16 fraudulent appraisals for $4,001,950 in loans originated at the mortgage company. Christian falsified the appraisals by using fake photos and descriptions of the properties, misrepresenting the condition of the properties, and used inappropriate comparable properties. The total loss for the 16 loans amounted to $2,440,804, including $814,730, to the Federal Home Loan Mortgage Corporation (Freddie Mac) and $757,293 to the Federal National Mortgage Association (Fannie Mae). Fannie Mae and Freddie Mac are government sponsored federally chartered corporations that either buy mortgages on the secondary market for their own accounts or arrange to pool the mortgages and sell them as mortgage backed securities to investors on the open market.

In March and June 2007, Christian used Goldberg as the mortgage broker to refinance property that he and his wife owned in Catonsville. Christian submitted false appraisals that inflated the property value and caused another appraiser to sign the documents to avoid the obvious conflict of performing an appraisal on his own property. With Christian's knowledge, Goldberg processed the loan in Christian's wife's name, falsifying her income and employment, as well as the balance in the couple's bank account and misrepresented other information. The loans were funded by another mortgage company, and Christian and his wife eventually defaulted on the loan, resulting in a loss of nearly $140,000.

Joshua S. Goldberg was indicted on related charges earlier this year. He is believed to be a fugitive.

The Maryland Mortgage Fraud Task Force was established to unify the agencies that regulate and investigate mortgage fraud and promote the early detection, identification, prevention, and prosecution of mortgage fraud schemes. This case, as well as other cases brought by members of the task force, demonstrates the commitment of law enforcement agencies to protect consumers from fraud and promote the integrity of the credit markets. Information about mortgage fraud prosecutions is available on this website: www.justice.gov/usao/md/Mortgage-Fraud/index.html.

This law enforcement action is part of President Barack Obama's Financial Fraud Enforcement Task Force. President Obama established the interagency Financial Fraud Enforcement Task Force to wage an aggressive, coordinated, and proactive effort to investigate and prosecute financial crimes. The task force includes representatives from a broad range of federal agencies, regulatory authorities, inspectors general, and state and local law enforcement who, working together, bring to bear a powerful array of criminal and civil enforcement resources. The task force is working to improve efforts across the federal executive branch and, with state and local partners, to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate financial crimes, combat discrimination in the lending and financial markets, and recover proceeds for victims of financial crimes.

United States Attorney Rod J. Rosenstein commended the FBI, Federal Housing Finance Agency-Office of Inspector General, and U.S. Postal Inspection Service. Mr. Rosenstein thanked Assistant U.S. Attorney Gregory R. Bockin, who prosecuted the case.[1]

**Silent Second:** The buyer of a property borrows the down payment from the seller through the issuance of a non-disclosed second mortgage. The primary lender believes the borrower has invested his or her own money in the down payment, when in fact, it is borrowed. The second mortgage may not be recorded to further conceal its status from the primary lender.

***Example:*** The fraud can be as simple as the following. The buyer and seller agree on a $100,000 sales price. The buyer can get an 80% LTV, but doesn't have the $20,000 required for the down payment. To make the deal work, the seller accepts a "silent second" mortgage for $15,000. As far as the first mortgage lender knows, the down payment is $20,000, but in fact, it is only $5,000.

[1] http://www.fbi.gov/baltimore/press-releases/2013/catonsville-real-estate-appraiser-sentenced-to-prison-in-scheme-to-obtain-more-than-4-million-in-fraudulent-mortgage-loans

To take this example one step further, assume the $100,000 is an unwarranted sales price. The seller purchased the home for $80,000 and is flipping the home for the aggressive $100,000 sales price. The seller may even go on record with the $15,000 second loan, but then forgives the loan after closing.

**Foreclosure Schemes:** The perpetrator identifies homeowners who are at risk of defaulting on loans or whose houses are already in foreclosure. Perpetrators mislead the homeowners into believing that they can save their homes in exchange for a transfer of the deed and up-front fees. The perpetrator profits from these schemes by re-mortgaging the property or pocketing fees paid by the homeowner.

***Example:*** He was their last hope—about 250 Southern California homeowners facing foreclosure and eviction believed him when he said he could save their homes. But in reality, he was their worst nightmare—he ended up fleecing the homeowners for approximately $1 million…and not a single home was saved in the process.

Last week, Jeff McGrue, owner of a Los Angeles-area foreclosure relief business, was sentenced to 25 years in prison for defrauding people who were at the end of their rope. Even the federal judge who sentenced him called him "heartless."
LOS ANGELES—A Tacoma, Washington man was sentenced today to 25 years in federal prison for running a scheme that defrauded owners of distressed Southern California homes by promising to prevent foreclosure through the paying off of their mortgages, but in reality doing no more than sending their lenders fake notes, totaling $55 million, that were supposedly backed by Treasury bonds.

Jeff McGrue, 51, who was found guilty by a federal jury in January 2011 of four counts of mail fraud and four counts of passing fictitious government instruments to lenders and loan servicers, faced a statutory maximum sentence of 180 years in custody.

At the sentencing hearing, United States District Judge Otis D. Wright, III, stated that the defendant intended to "bilk the financial institutions out of at least $55 million," and he described defendant's defrauding of the homeowners as "heartless."

United States Attorney André Birotte Jr. stated: "Schemes targeting homeowners who are losing, or are in danger of losing, their homes to foreclosure prey upon the most vulnerable among us. The Department of Justice is working with its partners in law enforcement to aggressively combat these schemes. This sentence will send a strong message of deterrence to scam artists and other schemers who think they can steal from desperate, distressed homeowners and get away with it."

The evidence presented during a four-day trial in United States District Court showed that McGrue orchestrated the foreclosure-rescue scheme from the fall of 2007 through the fall of 2008 through a company he called "Gateway International." McGrue worked with two others—Gerald Guidry, who owned a company called My Debt Solutions, and

Ronald Morgan, who owned a company called Omnipoint—to defraud 250 Southern California homeowners by promising to delay or prevent foreclosures and to pay-off delinquent mortgages in exchange for the homeowners making payments and transferring title to Gateway International.

McGrue and the others identified homeowners who were facing foreclosure or who were "upside-down" on their mortgages. Relying on a network of "consultants," many of whom were real estate agents, McGrue recruited these homeowners into his "Gateway Program." Through the Gateway Program, McGrue and the others falsely told homeowners that, if they paid an enrollment fee and monthly rent and signed over title of their homes to Gateway, McGrue would use "bonded promissory notes" purportedly drawn on a U.S. Treasury Department account to pay off their mortgages, thereby stopping foreclosure proceedings. The homeowners were falsely told that lenders were legally required to accept the notes, that they would be able to buy their homes back from Gateway International at a discount, and that they would receive up to $25,000, even if they chose not to re-purchase their houses.

In reality, McGrue did not own any bonds and did not have a U.S. Treasury Department account. Nor could he have the type of account described to homeowners because the Treasury Department does not maintain accounts that can be used to make payments to third parties.

McGrue and his co-schemers enrolled more than 250 victims in the "Gateway Program," but McGrue did not save a single home. McGrue collected approximately $1 million in the form of enrollment fees and rent from these victims. The evidence at trial showed that McGrue signed bogus documents to make it appear the victims' outstanding mortgages had been paid off so he could re-sell the victims' properties, which had been re-titled in Gateway's name, to unsuspecting buyers.

Guidry, a 44-year-old Lancaster resident, pleaded guilty last year to conspiracy and making false statements. He faces a statutory maximum sentence of 10 years in federal prison when he is sentenced by Judge Wright on October 17.

Morgan, a 52-year-old resident of Sumner, Washington, pleaded guilty last year to conspiracy. He faces a statutory maximum sentence of five years when he is sentenced by Judge Wright on November 7.

A fourth defendant charged as a result of the investigation, John-Pierre Rivera, of Los Angeles, participated in part of the scheme with McGrue. Rivera pleaded guilty last year to tax evasion. Rivera is scheduled to be sentenced by Judge Wright on November 28, at which time he faces a statutory maximum sentence of five years in federal prison.

The investigation into this mortgage foreclosure scheme was conducted by the Federal Bureau of Investigation.[1]

[1] http://www.fbi.gov/losangeles/press-releases/2011/washington-state-man-sentenced-to-25-years-for-orchestrating-foreclosure-rescue-scheme

**Air Loans:** This is a non-existent property loan where there is usually no collateral. An example of an air loan would be where a broker invents borrowers and properties, establishes accounts for payments, and maintains custodial accounts for escrows. The broker may set up an office with a bank of telephones, each one used as the employer, appraiser, credit agency, etc., for verification purposes.

> ***Example***: LAS VEGAS—Following approximately three weeks of trial, a lawyer from Louisiana who had worked locally as a real estate agent has been convicted by a jury of conspiracy and multiple fraud counts for his involvement in the mortgage fraud scheme involving over 220 properties and over $50 million in losses, announced Daniel G. Bogden, United States Attorney for the District of Nevada.
>
> David M. Mark, 37, of New Orleans, Louisiana, was convicted on Thursday, April 11, 2013, of one count of conspiracy to commit bank, wire, and mail fraud; two counts of bank fraud; and one count of mail fraud. Mark is free on a personal recognizance bond and is scheduled to be sentenced by Senior U.S. District Judge Philip M. Pro on July 29, 2013, at 10:00 a.m. Mark faces up to 30 years in prison on the conspiracy and bank fraud counts and up to 20 years in prison on the mail fraud count. Mark also faces fines of up to $1 million on the conspiracy and bank fraud counts and up to $250,000 on the mail fraud count.
>
> According to the indictment and evidence presented to the jury during the trial, Mark was employed as a real estate agent and transaction coordinator at Distinctive Real Estate and Investments, a company owned and operated by co-conspirator Eve Mazzarella who was convicted of fraud in December 2011 and sentenced to 14 years in prison. From about March 2006 to December 2007, Mark solicited persons with good credit to act as straw buyers to purchase homes in the Las Vegas area. Mark made arrangements to purchase the homes above the sellers' asking prices and made arrangements for the excess funds to be redirected to business entities controlled by his coconspirators under the pretense that they would make upgrades or perform repairs to the properties.
>
> Mark caused the straw buyers to apply for mortgage loans for the homes, knowing that the straw buyers could not afford and did not intent to make the mortgage payments. Mark caused false information concerning income, employment, assets, liabilities, and intent to occupy the homes to be placed in the straw buyers' loan applications. Once the mortgage loans were approved by the financial institutions, Mark caused the financial institutions and escrow and title companies to make third party disbursements to shell companies controlled by his co-conspirators who had an interest in the transactions. Mark's co-conspirators defaulted on the mortgage payments, causing the properties to go into foreclosure and causing losses to the financial institutions of more than $50 million.

The case was investigated by the FBI and is being prosecuted by Assistant U.S. Attorneys Brian Pugh and Sarah E. Griswold.[1]

[1] http://www.fbi.gov/lasvegas/press-releases/2013/louisiana-lawyer-convicted-in-nevada-mortgage-fraud-scheme

# Consumer Protection

## A. Borrower Advisory

Here are a few tips to help borrowers protect themselves against mortgage fraud:

- Have consumers get referrals for real estate professionals and check licenses
- If it sounds too good to be true, it probably is
- Inform consumers to be wary of high-pressure sales tactics
- Have consumers look at recent comparable sales and tax assessments to verify property values
- Encourage borrowers to understand what they are signing and to not sign any blank documents
- Review title history of the home to determine if there was a history of flipping
- Encourage consumers to understand the terms of their mortgage and verify accuracy of the application

## B. Fraud Prevention Measures

### *Indicators*

The following is a non-exhaustive list of indicators which may suggest possible mortgage fraud:

- Inflated appraisals;
- Exclusive use of one appraiser;
- Increased commissions/bonuses for brokers and appraisers;
- Bonuses paid (outside or at settlement) for fee-based services;
- Higher than customary fees;
- Falsifications on loan applications;
- Buyers told/explained how to falsify the mortgage application;
- Request to sign blank forms or application;
- Fake supporting loan documentation;
- Purchase loans disguised as refinance so as to require less documentation and lender scrutiny;

- Short-term investments with guaranteed re-purchase agreement;
- Investors used to flip property prices for fixed percentages;
- Multiple "holding companies" utilized to increase property values.

## *General advice*

- Get a referral for real estate and mortgage professionals;
- Check the licenses of the industry professionals with state, county, or city regulatory agencies;
- If it sounds too good to be true, it probably is - an outrageous promise of extraordinary profit in a short period of time signals a problem;
- Be wary of strangers and unsolicited contacts, as well as high-pressure sales techniques;
- Look at written information to include recent comparable sales in the area, and other documents such as tax assessments to verify the value of the property;
- Understand what the borrower has to sign and ask them to sign and agree to it - if you do not understand completely, re-read the documents, or seek assistance from an attorney;
- Make sure the name on the application matches the name on the identification furnished by the borrower;
- Review the title history to determine if the property has been sold multiple times within a short period - that could mean that this property has been "flipped" and the value falsely inflated;
- Know and understand the terms of the mortgage - check the information against the information in the loan documents to ensure they are accurate and complete;
- Never sign any loan documents that contain blanks, as this leaves you vulnerable to fraud

# Ethical Considerations for Mortgage Professionals

## A. Fiduciary Duties

A fiduciary is someone who has undertaken to act for and on behalf of another person in a particular matter in circumstances which give rise to a relationship of trust and confidence.

A fiduciary (abbreviation fid) is expected to be extremely loyal to the person to whom he owes the duty (the 'principal'): he must not put his personal interests before the duty, and must not profit from his position as a fiduciary, unless the principal consents. The word itself comes originally from the Latin *fides*, meaning faith, and *fiducia*, trust.

Fiduciary responsibility applies to mortgage lending in the communication of the loan originator to the loan applicant regarding:

- Recommendations for specific loan types
- Applicant's understanding of pre-payment penalties
- Applicant's understanding of payment increases
- Applicant's understanding of negative amortization and its impact

There are 2 elements of fiduciary duty for the mortgage professional:

- To the borrower
- To the lender/investor

Certain states, such as California and Minnesota, require MLOs to have a fiduciary duty to the borrower in their licensing and predatory lending laws.

### *Fiduciary Duty to the Borrower*

When a consumer uses an MLO to obtain a loan, a principal and agent relationship is developed, and the MLO owes fiduciary duties to the borrower.

As an agent, a mortgage professional owes fiduciary duties to the borrower. These duties include:

- Loyalty
- Good faith
- Obligation to the interests of the borrower ahead of the MLO

MLOs are the professionals, so borrowers expect them to be:

- Knowledgeable
- Working on their behalf
- Helping them to make the ’best‘ decision

When an MLO is working as an intermediary, this means that the MLO is not the ultimate decision maker rather the borrower is for the definition of the ’best‘ loan:

- MLOs agree to their lender/investor/broker that they are delivering loans that meet program guidelines and were originated in the absence of fraud or malice

**AND/OR**

### *Fiduciary Duty to the Lender*

MLOs are intermediaries between consumers and lenders and owe no particular responsibility to the borrower as they are ultimately responsible for understanding loan terms and making the decision to go forward with the loan.

## B. Code of Ethics

A code of ethics for each profession is a set of standards for professionals in that field to follow. The National Association of Mortgage Brokers (NAMB) has developed a set of ethics and believes that the interests of the public and private sector are best served through the voluntary observance of ethical standards of practice, hereby subscribing to their code of ethics. A code of ethics is not just for the community of professionals and for individuals, but it is critical for company policy and should be communicated to employees.

- **Honesty and Integrity:** NAMB members shall conduct business in a manner reflecting honesty, honor, and integrity.
- **Professional Conduct:** NAMB members shall conduct their business activities in a professional manner. Members shall not pressure any providers of services, goods, or facilities to circumvent industry professional standards. Equally, members shall not respond to any such pressure placed upon them.
- **Honesty in Advertising:** NAMB members shall provide accurate information in all advertisements and solicitations.
- **Confidentiality:** NAMB members shall not disclose unauthorized confidential information.
- **Compliance with Law:** NAMB members shall conduct their business in compliance with all applicable laws and regulations.
- **Disclosure of Financial Interests:** NAMB members shall disclose any equity or financial interest they may have in the collateral being offered to secure a loan.