

Consumer Financial Services Enforcement and Litigation Special Mortgage Fraud Update

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This periodic newsletter to our clients and friends is designed to communicate the latest developments in the consumer financial services litigation, enforcement, and compliance areas. We welcome your comments, feedback, and suggestions for issues to address in our next newsletter.

Argent Mortgage Company Voluntarily Agrees to Cease and Desist Order Issued by Georgia Department of Banking and Finance

On September 6, 2005, Argent Mortgage Company ("Argent") voluntarily consented to a final cease and desist order issued by the Georgia Department of Banking and Finance ("Department"). The Cease and Desist Consent Order directed Argent to adopt policies and procedures that comply with applicable state laws and regulations, enhance its broker approval and review process, and report suspected mortgage fraud activity by a broker to the Department.

Argent also agreed to implement a set of best practices that derived largely from a Federal Financial Institutions Examination Council white paper issued in February 2005 entitled, *The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper*. The Consent Order requires Argent to adhere to the following standards:

- **Broker Monitoring:** Monitor closely new brokers, correspondents and products, develop a broker scorecard using objective criteria (e.g., volume, prepayments, credit quality, fallout, FICO scores, loan to values, debt to income ratios, delinquencies, early payment defaults, foreclosures, fraud, documentation, deficiencies, repurchases, timely loan package delivery, concentrations, and quality control findings), and perform due diligence of brokers and correspondents, including adverse database searches during the broker approval process.
- **Employee Training:** Train employees on common mortgage fraud schemes, proper loan origination and closing procedures, and regulatory compliance. Establish a list of "red flags" for underwriting and post-closing audits, and update the list as mortgage fraud schemes evolve.

- ***Pre-funding Reviews:*** Ensure that pre-funding reviews include triggers for verification/re-verification of applicant information such as income, assets, employment, rent, and Social Security Number.
- ***Underwriting Policies:*** Implement "Common Sense Underwriting" procedures to ensure that terms and conditions of loan programs match the status of the borrowers (*e.g.*, a salaried, large firm employee should apply for a full document program rather than a stated income loan).
- ***Anti-Flipping:*** Comply with Department guidelines by not approving any purchase transaction for a property that has been sold within the past 12 months and using the prior sales price for refinances with property sold in the past 12 months (provided the price is considered to be the fair market value).
- ***Property Occupancy Status:*** Establish methods for detecting the occupancy status of residences, namely whether the property is a primary residence or investment property.
- ***Closing Agents:*** Provide objective requirements to closing attorneys or agents, which include, at minimum, the following closing instructions:
 - Obtain and review identification on all parties to the transaction, and keep records of parties attending the closing.
 - No payments from closing funds or liens, invoices, etc. shall be made that have either not been filed with the appropriate recording official or that have been filed within seven days of the closing date.
 - No payments may be disbursed from closing funds unless the transaction is disclosed on the Settlement Statement.
 - Verify, where possible, that down payment funds presented at closing come from the borrower and not a third party.
 - Accept certified funds only from the financial institution that is the verified depository.
 - Notify Argent if the closing attorney has knowledge of a previous, concurrent, or subsequent primary residential loan transaction involving the borrower or the subject property within the prior 12 months.

- **Appraisal Review:** Strengthen the appraisal review process or outsource the review as needed.
- **QA Reviews:** Increase the number of Georgia loans reviewed by Quality Assurance from 10 percent to at least 25 percent.

Argent agreed to provide the Department with a written progress report within 90 days of the Consent Order summarizing the actions taken to comply with the terms set forth above. For more information, visit the Department's website: www.gadbf.org.

FBI's Statistics in Financial Crimes Report Indicate Emerging Trends in Mortgage Fraud

The Federal Bureau of Investigation ("FBI") issued its *Financial Crimes Report to the Public* in May 2005, which contains a section on mortgage fraud. The Report identifies 26 states as having significant mortgage problems based on recent mortgage industry surveys. Georgia and Florida are the most frequently identified problem states. Other regions with high concentrations of mortgage fraud problems include the South, Southwest, and West.

According to the Report, the number of mortgage fraud related violations reported in Suspicious Activity Reports increased from 4,225 in 2001 to 17,127 in 2004. The Report also shows a rise in pending fraud cases over the past two years. In 2003, there were 436 pending mortgage fraud cases. That number grew to 534 cases in 2004 and jumped to 642 cases in only the first two quarters of 2005. The statistics also showed increases in mortgage fraud related informations and indictments, recoveries, fines and seizures. For a copy of the report, visit www.fbi.gov/publications.htm.

FFIEC Issues White Paper on Third Party Mortgage Loan Fraud

As referenced above, the Federal Financial Institutions Examination Council ("FFIEC") issued a white paper in February 2005 entitled *The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper*, ("White Paper") which served as the basis for many of the standards set forth in the Argent Consent Order.

The White Paper is based on work undertaken at the FFIEC's Fraud Investigations Symposium, in late 2003, and is divided into four sections. The first section provides background information on the steady increase of third party mortgage fraud and

explains the three motives for such schemes: fraud for profit, fraud for housing, and fraud for other criminal purposes.

The second section identifies key third parties typically involved in residential mortgage lending, namely the buyer, seller, real estate agent, originator, processor, appraiser, underwriter, warehouse lender, and closing/settlement agent. This section also explains basic processes for loan origination and acquisition.

The third section describes common third party mortgage fraud mechanisms and schemes. The section also lists "red flags," internal controls and best practices for various stages of the loan process designed to help financial institutions detect and prevent the incidence of mortgage fraud. The "red flag" topics include: applications, appraisals, credit reports, escrow/closing, mortgage brokers, title insurance/opinion, and verification of employment and deposits.

The fourth section provides tips to examiners in conducting examinations. This section also suggests measures that financial institutions can take to mitigate the risk of falling victim to third party mortgage fraud, namely reporting potential fraud or misconduct to the Financial Crimes Enforcement Network through a Suspicious Activity Report and, where appropriate, the state appraiser board.

The FFIEC White Paper is available online at www.ffiec.gov/exam/3P_Mtg_Fraud_wp_oct04.pdf.

U.S. Attorney for Eastern District of Pennsylvania Enters Joint Agreement with Option One Mortgage Corporation to Help Combat Mortgage Fraud

On March 16, 2005, U.S. Attorney Patrick L. Meehan announced a Joint Agreement with Option One Mortgage Corporation ("Option One") regarding Option One's mortgage fraud detection and prevention program. The U.S. Attorney's Office for the Eastern District of Pennsylvania learned through its investigation that independent mortgage brokers had submitted fraudulent loans to Option One in the form of inflated appraisals, fictitious charitable grants applied toward down payments, misrepresentations of cash brought to closing, and excessive broker's fees, which were used to recoup funds that brokers provided to borrowers for down payments.

In response to the government's inquiry, Option One began a comprehensive review of its internal controls for fraud detection and prevention, which led to the enhancement of many fraud-related policies and procedures, including:

- Reorganization of the corporate reporting structure and the addition of several new positions dedicated to the detection and prevention of fraud.

- Revision of fraud-related policies and the creation of new anti-fraud policies (*e.g.*, source and seasoning policy, anti-flipping policy).
- Development of regularized targeted reviews of brokers and account executives designed to identify instances of fraud and the perpetrators.
- Provision of specialized training to employees and third parties (*e.g.*, business partners) to increase fraud awareness.
- Institution of regularized reports by the Chief Risk Officer to the Audit Committee of the parent company's Board of Directors.
- Creation of an anonymous hotline to which Option One employees can submit inquiries and concerns about potential wrongdoing. Oversight of the hotline will be assigned to the Chief Risk Officer.
- Demonstration of a company-wide commitment to combating mortgage fraud.
- Creation of two fraud prevention committees: one comprised of senior management and the other comprised of personnel from several departments having fraud detection and prevention responsibilities.
- Assignment of the Risk Mitigation Department to (1) investigate and take action on potential fraud and other misconduct (with the assistance of the Corporate Appraisal and Closing Departments in their respective areas); and (2) conduct pre-funding and post-funding reviews of loan files.
- Implementation of stringent procedures on broker approval, broker review, and broker disciplinary action, including use of a watch list and suspension list.
- Execution of in-depth branch investigations upon suspicion of fraudulent activity at the branch level.

Option One was praised by the U.S. Attorney's Office in the Joint Agreement for being forthcoming, responsive, cooperative and receptive to suggestions during the Government's inquiry.

For more information about the Joint Agreement or Option One's Statement of Fraud Detection and Prevention Program, visit www.usdoj.gov/usao/pae/.

Note: The Washington, DC Office of Skadden, Arps represented Option One in connection with the Government's inquiry and Joint Agreement.

Market Street Mortgage Corporation Enters Settlement Agreement with U.S. Government for Alleged Violations of the False Claims Act

On August 3, 2004, the United States Attorney's Office for the Eastern District of Pennsylvania announced a settlement agreement with Market Street Mortgage Corporation ("Market Street") settling allegations that Market Street provided the Department of Housing and Urban Development and the Department of Veterans Affairs with false and fraudulent claims. Between March 1, 1999 and September 22, 2000, Market Street allegedly submitted false and fraudulent documents relating to loan applicants' employment, "gift" letters, credit references, and Social Security documents to qualify certain applicants for government loans. When some of the borrowers defaulted on their loans, Market Street sought reimbursement of losses from foreclosures on the government insured residential loans.

Market Street agreed to pay \$700,000 to reimburse the government for losses on which it demanded payments. Market Street will also indemnify the government from potential losses relating to 83 specific mortgages which contain a face value exceeding \$5 million. For more information about *United States ex rel. Smith v. Market Street Mortgage Corp.*, Civ. A. No. 99 CV 6605 (E.D. Pa.), visit www.usdoj.gov/usao/pae/.

Consumer Financial Services Enforcement and Litigation Group

The Consumer Financial Services Enforcement and Litigation Group at Skadden, Arps, Slate, Meagher & Flom LLP and affiliates ("Skadden, Arps" or "Skadden") represents many of the nation's leading banks, insurance companies, securities firms and other consumer financial services companies in a broad array of government investigations, enforcement actions and class action litigations focused on the sale of financial products to consumers. The group comprises more than 20 Washington, D.C.-based lawyers with extensive experience as federal prosecutors and financial services regulators, and in defending corporations in civil and criminal governmental investigations. The group also includes litigation partners and associates in the firm's New York, Boston, Chicago, San Francisco and Los Angeles offices. Drawing upon the resources of the firm's litigation, banking and insurance practice areas, the Consumer Financial Services Enforcement and Litigation Group is highly experienced in handling matters involving concurrent federal and state investigations and multiple private class action lawsuits. The group also has an active examination and regulatory compliance practice that provides ongoing advice regarding day-to-day compliance, regulatory examinations and the acquisition approval process, as well as litigation risk management. The group regularly performs due diligence for clients considering strategic partnerships or acquisitions.

Enforcement

Our active enforcement practice includes the representation of financial services companies in investigations and litigations brought by the U.S. Department of Justice ("DOJ"), the Federal Trade Commission ("FTC"), the Securities and Exchange Commission ("SEC"), the Department of Housing and Urban Development ("HUD"), the National Association of Securities Dealers ("NASD"), federal bank regulators, state attorneys general, and other federal and state enforcement and regulatory agencies. We represent financial services firms in investigations and regulatory examinations focused on consumer lending and securities sales practices, fair lending and fair access, consumer privacy and information security. We also regularly represent clients in regulatory examinations and investigations related to the U.S.A. Patriot Act, the Bank Secrecy Act and regulations of the Office of Foreign Assets Control ("OFAC").

Litigation

We regularly represent financial services companies in federal and state consumer class action litigation. We have recently represented clients in class actions involving claims under the Fair Housing Act, the Equal Credit Opportunity Act, the Civil Rights Acts, federal securities laws, unfair and deceptive business practice statutes, and pursuant to state consumer protection, sales practices, privacy and antidiscrimination statutes. Our consumer class action defense practice is part of

Skadden's litigation practice consisting of more than 100 partners and 360 associates. Our litigators have represented major corporations in hundreds of class action lawsuits and utilize a state-of-the-art technology infrastructure enhancing the firm's productivity and efficiency.

Counseling and Compliance

An important part of our practice involves counseling financial services clients, including banks and thrifts, credit card and consumer finance lenders, and mortgage companies and insurance providers, on a broad range of examination, compliance and risk management issues. Recent engagements include the development and implementation of comprehensive compliance management programs addressing the written policies, training and ongoing monitoring necessary to ensure corporate-wide compliance with fair lending laws, federal and state consumer protection statutes, consumer financial privacy and information security regulations, antimoney laundering requirements of the U.S.A. Patriot Act, the Bank Secrecy Act and OFAC. We also have conducted independent assessments and provide ongoing advice regarding clients' existing compliance and self-assessment programs. We regularly conduct regulatory and legal risk assessments for clients considering acquisitions or strategic alliances with other financial services companies.

Our Consumer Financial Services Enforcement and Litigation Group provides advice to clients in connection with preparing for and managing the regulatory examination process and acquisition approval process, as well as helping management respond to examination findings. We also provide ongoing advice regarding requirements of the Community Reinvestment Act ("CRA"), and develop CRA plans and strategies.

Book Information

Our book, *Consumer Financial Services*, has been updated and expanded. To order your copy, visit www.lawcatalog.com.

Contact Information

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