

How Mortgage Fraud Helped Sink the Economy

The Build-Up to the Great Financial Meltdown

To understand how pervasive mortgage fraud has become in the United States, consider Unit 602. A condominium on Island Drive in the newly fashionable stadium district of downtown San Diego, Unit 602 has a lofted ceiling, marble countertops and a terrace with a view of the skyline. Built in 2002, the unit originally sold in 2003 for \$629,000, when the new building, designed to recall a historic warehouse, was a coveted location in Southern California's white-hot real estate market.

FORECLOSED

**FOR SALE
BY OWNER**

In January 2006 the owners of Unit 602 put the condo up for sale. The asking price was \$925,000. For months, it didn't sell. So the owners re-listed it. Instead of lowering the price, as would be expected, they raised it to \$1.1 million. Within days, it sold.

"Whenever a property that doesn't sell gets re-listed and sells the next day at a higher price, that should be a huge red flag to the lender," said Curtis Novy, a longtime underwriter in San Diego and expert in mortgage fraud who trains prosecutors about the crime.

Rather than investigate, a bank approved a loan. The mortgage broker fraudulently hiked the sale price by \$175,000 and claimed most of the additional loan money as his fee. According to court records, the San Diego County prosecutor's office established, and the court agreed, that this constituted loan fraud. The home was purchased in the name of Gloria Angundez, but the real Angundez later said that she was never involved. Someone else bought the condo using her stolen identity.

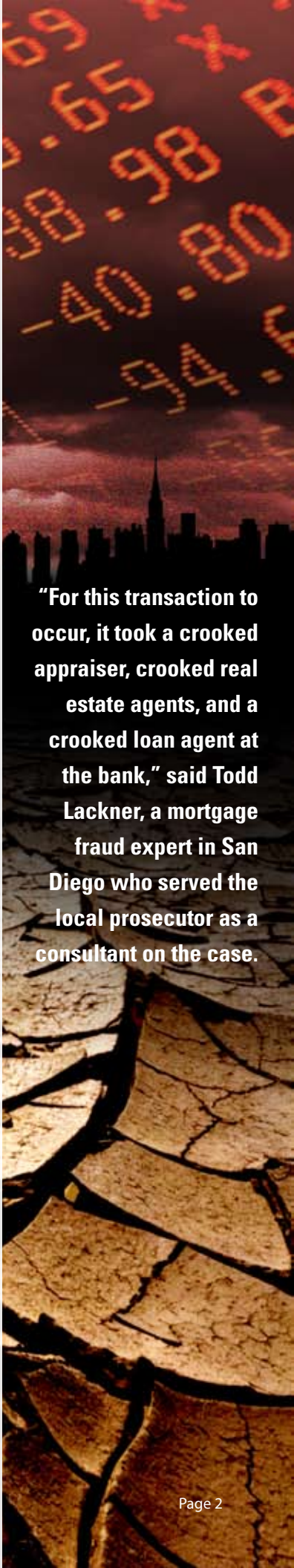
Whoever actually bought Unit 602 didn't keep up with the payments. (And why should they? He or she already had received a payoff, and the property never was worth a million dollars anyway.) So, Unit 602 went into foreclosure. The price dropped, then dropped some more, until in February of 2008 it was sold for \$591,200. The bank was left holding the bag for half a million dollars .

And here's the truly scary part: The fraud of Unit 602 was not the work of a single criminal. It involved a number of parties to the deal.

"For this transaction to occur, it took a crooked appraiser, crooked real estate agents, and a crooked loan agent at the bank," said Todd Lackner, a mortgage fraud expert in San Diego who served the local prosecutor as a consultant on the case. "Everybody knew exactly what was happening. And it happened dozens and dozens of times in downtown San Diego alone."

A slow build to the inevitable

After years of silent growth, the mortgage fraud epidemic finally burst into public view as a major cause of the current global economic crisis. A series of factors including deregulation of the banking industry under Presidents Clinton and Bush; a multi-year campaign by the U.S. Federal Reserve to spur the economy by keeping interest rates at historic lows; federal programs encouraging lenders to give mortgages to people who traditionally wouldn't have qualified; and the proliferation of the secondary debt market, which allowed lenders to rid their balance sheets of risky debt by passing it on to investors worldwide; all culminated in a terrifying plunge. The Dow Jones Industrial Average recorded its largest single-day loss ever. Countries around the world partially nationalized their largest banks to prevent them from collapsing, and later were forced to inject hundreds of billions of dollars into the credit markets because banks and corporations lost faith in each other's ability to repay short-term debts. Iceland became the first nation ever to declare bankruptcy, with Pakistan close on its heels.



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At the center of all this tumult lies a once-mundane little document: the mortgage on an American house. As banks competed throughout the 1990s and the first half of this decade to beat one another's quarterly profit reports, many stopped paying as much attention to mortgage statements as they used to.

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Crooks recognized an opportunity. So they seized it. They paid appraisers to fraudulently inflate the value of homes. They recruited straw buyers to purchase multiple houses at the new, higher prices, gave their partners a cut, and stole the rest of the bank loan. Some lenders got into the act. They tricked low- and fixed-income homebuyers into mortgages with hidden balloon payments and interest rates that would climb like a ladder after the first year or two. When the buyer could no longer afford the mortgage, the lender would foreclose, then sell the home to someone else.

"The current housing crisis has shown us that while some homeowners unfortunately made poor financial decisions, others were clearly taken advantage of by bad actors in the housing industry," Mel Martinez, a Republican Senator from Florida and former secretary of U.S. Housing and Urban Development, said in a press release.

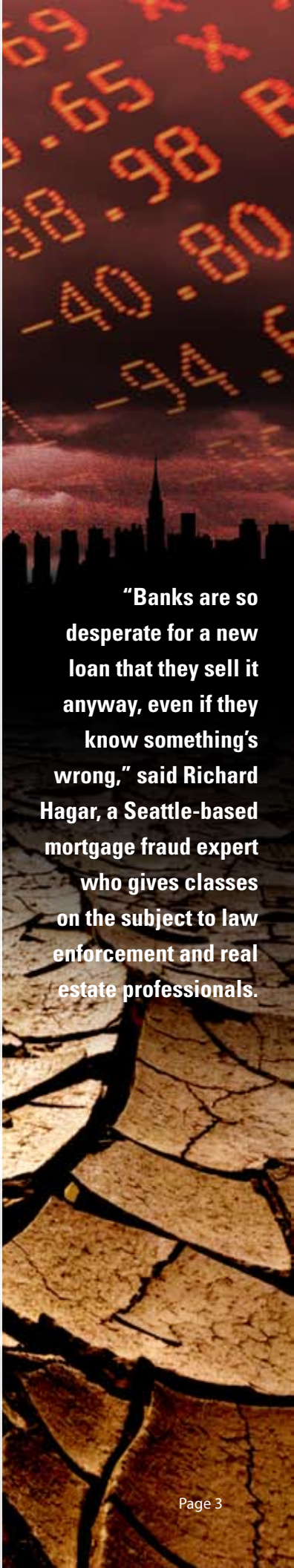
All of these schemes flooded the global financial system with billions of dollars in mortgage debt that would never—could never—be repaid. And yet even under the harsh light of the current crisis, mortgage fraudsters are adapting, still finding new ways to operate.

"Honestly I don't think we're making much of a dent," says FBI Agent David Morgan, who leads the anti-mortgage fraud squad in the FBI's field office in Cleveland, Ohio, one of the cities that has been hardest hit by fraud. "Mortgage fraud is still happening. It's big business."

Government scrambles to catch up, but only falls further behind

Of course, it's difficult to make much of a dent when you have fewer investigators assigned to the job. According to FBI data uncovered recently by The New York Times, today there are 625 fewer FBI agents working white collar cases—including mortgage fraud—than there were in 2001, a 36-percent drop. The staffing cut occurred soon after Sept. 11, when the bureau shifted 1,800 agents, or almost a third of its investigators, to intelligence and anti-terrorism duties, the Times reported. Numerous requests by FBI leaders for funding to hire more agents and rebuild its white-collar crime team were denied by Congress and The White House.

The effect on mortgage fraud investigations was immediate and dramatic. In 2004, a senior FBI official warned of an oncoming "epidemic" of mortgage fraud. But in 2005, the bureau had just 15 of 13,000 agents investigating mortgage fraud.



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"They were very late to the game," Congresswoman Zoe Lofgren, a California Democrat, was quoted by The New York Times in regards to the FBI's handling of the mortgage crisis. "They were not on top of this, and they're just now starting to really do something."

Staffing has rebounded somewhat since 2005. There are now 177 agents working mortgage fraud cases, according to the FBI. Meanwhile, state and local police departments have picked up many of the cases that the FBI no longer has the bandwidth to investigate.

Increased state and local involvement has led to a wave of legislation across the country as state leaders attempt to respond. Governors in Arizona, Michigan, Maryland and Missouri have signed bills making mortgage fraud a crime.

But even now, after elected officials at all levels of government have held hearings on mortgage fraud, introduced and passed laws cracking down on the crime, and served notice to all fraudsters that they are now being watched, the crime continues, evolves and grows. In late June, the U.S. Department of Justice announced it had arrested 406 people since March accused of mortgage fraud, including 60 arrested on a single day.

"To those who would contemplate misleading, engaging in such schemes, you will spend time in jail," announced FBI director Robert Mueller. The FBI's actions are having an impact, according to some mortgage fraud experts. Fear of imprisonment and the huge downturn in the housing market have combined to slow or stop many professional scammers.

"Right now the mentality is that if somebody is going to commit fraud in the mortgage arena, they're going to be very, very careful," says Novy.

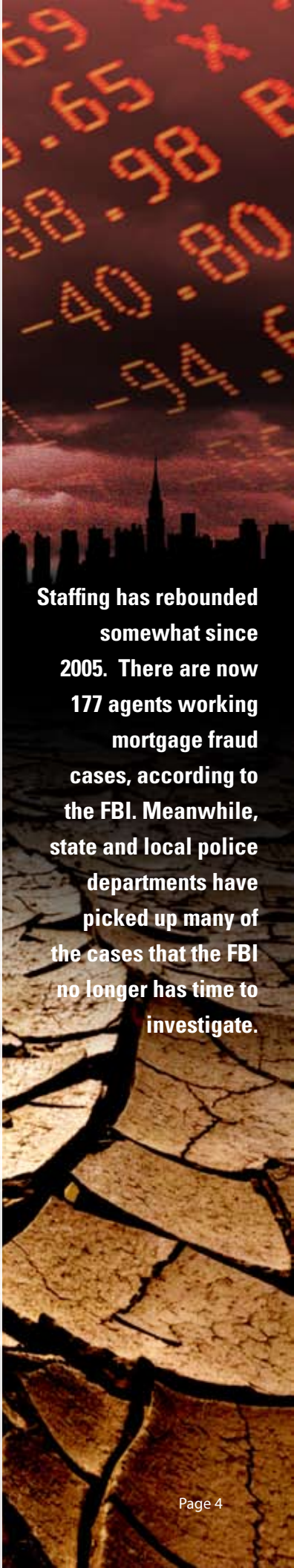
But other analysts believe these efforts by the FBI, Congress and the states are too little, too late. As federal, state and county courts become backlogged with mortgage fraud cases, they say, scammers simply are switching tactics, pursuing fraudulent schemes that work best in a declining economy.

"After years of sticking their heads in the sand, law enforcement is taking mortgage fraud much more seriously than it used to," says Robert Strupp, director of research and policy for the Community Law Center in Baltimore. "But now there is a serious capacity problem. Regulators and prosecutors don't have enough staff to keep up with all the new types of fraud."

In fact, the FBI predicted just such a scenario. In its April, 2008 report on mortgage fraud, the bureau said that continued pain in the housing market would lead to continued profits for scammers.

"The current and future market conditions will have mortgage industry professionals pursuing a smaller pool of customers," the report said. "As such, professional fraudsters will devise new and improved schemes to exploit the weaknesses in the housing market."

And mortgage fraud investigators within the bureau wonder just how much an impact they're



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actually making. "I doubt whether we've had the effect of deterring fraudsters yet," says FBI agent Morgan. "What I'm seeing instead is a dramatic increase in the sophistication of their efforts to avoid detection."

A spike in fraud

An incomplete barometer of mortgage fraud trends comes by way of Suspicious Activity Reports (SARs), in which financial institutions are required to state some of the losses that they suspect were due to fraud. (Many types of suspected fraud are not subject to such reporting laws.) Banks and other institutions filed 46,717 SARs in Fiscal Year 2007, for \$813 million in losses. That number of filings represents a 31 percent increase from 2006, and it was almost six times the number reported in 2003.

"The \$813 million statistic is significant," says the report, "as it hints to the total amount of financial institution and industry entity losses not subject to SAR filing."

In the long run, experts believe that increased enforcement likely will reduce the amount of mortgage fraud. But in the short term, more scrutiny will lead to a spike in reported suspicious activity, especially involving major players like Countrywide Financial, whose business model depended on predatory loans.

"I would guess that we'll see 65,000 SARs reports this year, and then I think that will be the peak," said Richard Hagar, a Seattle-based mortgage fraud expert who gives classes on the subject to law enforcement and real estate professionals. "By next year, the big players with bad attitudes...will be gone."

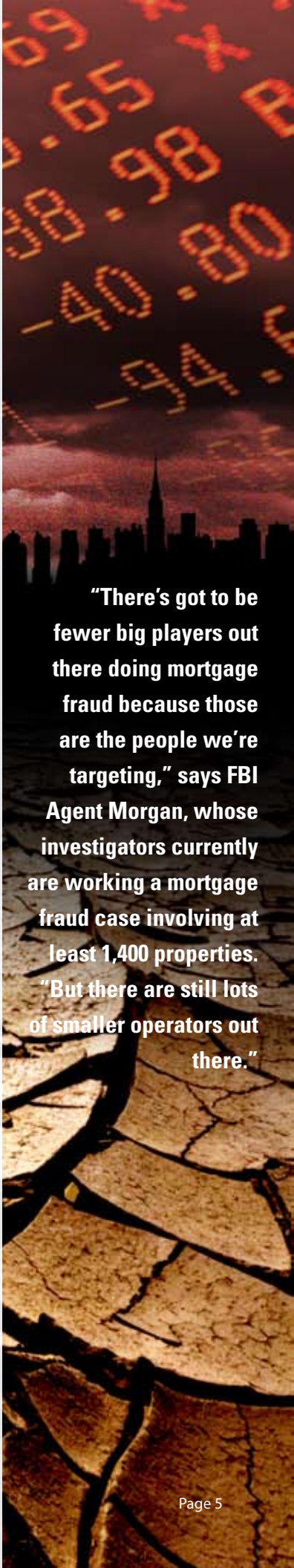
The new players will be smaller, but their attitudes may be even worse. A record 1.1 million homes are in foreclosure according to a June report by the Mortgage Bankers Association, with almost half a million new homes entering foreclosure every quarter. As many as 2.5 million foreclosures could occur this calendar year, Treasury Secretary Henry Paulson said in early July.

"There's got to be fewer big players out there doing mortgage fraud because those are the people we're targeting," says FBI Agent Morgan, whose investigators currently are working a mortgage fraud case involving at least 1,400 properties. "But there are still lots of smaller operators out there."

Kick them when they're down: Foreclosure fraud up

Homeowners facing foreclosure are especially desperate, and highly vulnerable to fraud. A new wave of foreclosure-related schemes have already begun to sweep the country, experts say. "Debt reduction and foreclosure scams, certainly we're seeing an uptick in those areas now," Morgan says.

In a common type of deal, the scammer will approach a homeowner facing foreclosure and offer, say, \$5,000 for a house worth \$200,000, Hagar says. Under the deal, the owner gets to



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continue living in the house, but the self-declared savior gets the deed. The former homeowner pays the "foreclosure expert" a monthly rent, with the oral agreement that in a year's time he or she will get full ownership of the house back.

Perhaps it's no surprise, however, that the "savior" (read: "scammer") uses any excuse he can to kick the former homeowner out of the house. In some cases, being ten minutes late with a rent check is enough to get the homeowner-turned-renter evicted, Lackner says. Which means the "rescuer" obtains full title to the house for pennies on the dollar.

"Oh yeah, these people are terrible," Lackner says.

An old ad, a new scam

During the height of the housing boom, highway off-ramps across the country were lined with little signs saying "We Buy Houses!" Most were seeking straw buyers for mortgage fraud scams. The signs disappeared from many cities in recent years, as the housing market slumped and cities used their zoning laws to prosecute sign-planting scammers.

Now the signs are back, analysts say, only the scam has changed. Instead of looking for straw buyers to purchase, say, 10 homes at a time, inflate the value and steal money from the bank, now the scammers are looking for homeowners facing foreclosure.

"Scammers are even posing as state-certified foreclosure consultants, when no state in the country gives such a certification," Strupp says.


A buyer's market = desperate sellers

Another growth area for mortgage fraud involves builders and condo developers looking to unload unwanted inventory, experts say. In a typical scam, a fraudster will buy a condo or a house in a new subdivision for about 20 percent more than the asking price, artificially driving up prices for the rest of the unsold units. Then the scammer enlists straw buyers to purchase the rest of the unsold units at inflated prices quickly, all on the same day or in the same week, faster than the banks can detect the fraud. The straw buyers, crooked appraisers and principal con man all take their cuts of the loan money, make a few payments, then default on the loans. The banks are left with an entire building or subdivision of foreclosed units, driving property values through the floor.

"These are desperation moves by the builder or the seller because they are teetering on bankruptcy," Lackner says. "You can see an entire neighborhood destroyed in a week."

How much for a good identity?

As lenders clamp down on credit and spend more time reviewing each loan, good appraisers and good borrowers will both be in higher demand, analysts say. Increasingly, scammers are stealing the identities of trusted home appraisers and using their stolen signatures to sign off on fraudulent loans.



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"It's called a ghost appraisal, where someone steals an appraiser's name and approves an inflated valuation," Lackner says. "It's really easy to do, and it happens all the time."

As the flow of borrowers dries up, consumers with good credit also are at greater risk of identity theft. "As financial institutions begin to enforce higher lending standards, the identities of individuals with good credit will increase in value to perpetrators," according to the FBI's report. "As such, individuals with good credit will likely be at a more significant risk for identity theft and mortgage fraud schemes, and the continued vulnerability of identifying information will allow perpetrators the accesses necessary to commit such schemes."

Some banks slow to change

And even though many banks are making headlines by tightening their lending requirements and seriously scrutinizing each loan, experts say plenty of lenders are still playing the boom-time game of writing as many loans as possible to prop up short-term profits, even if a high percentage of those loans are obviously fraudulent. Banks are still offering no-document loans to first-time homebuyers, Hagar says. Some are still giving a single loan for multiple properties without asking which of the units will be owner-occupied and which will be rented or re-sold, says Ralph Roberts, a longtime Michigan-based realtor who runs the anti-fraud news web site www.flippingfrenzy.com, and who trains state and local law enforcement agencies, regulators and financial institutions about mortgage fraud.

Which means now as then, some banks are complicit in mortgage fraud.

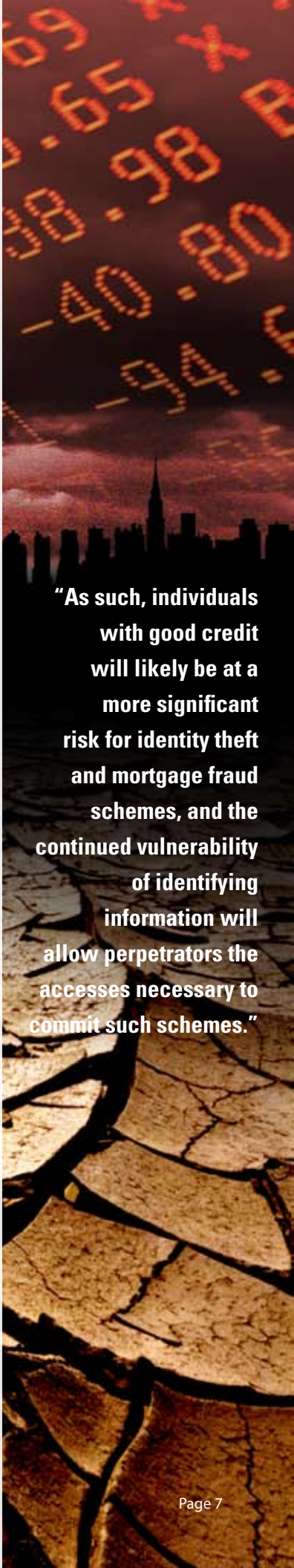
"The lenders are so desperate to get business that they still are writing loans that have no business getting approved," Roberts says. "They know exactly what is happening, and they don't care. Still."

"Some banks don't care," Hagar says. "The people in the trenches get it. They see the fraud before it happens. But they're getting so much pressure from higher management to sell the loans anyway so the company can get the loan fees and stay alive."

For its part, the FBI appears to understand that mortgage fraud often happens with the knowledge and support of banking and mortgage industry professionals. In its April report, the bureau instructed field agents to focus their investigations on industry insiders.

"Perpetrators in mortgage industry occupations are familiar with the mortgage loan process and therefore know how to exploit vulnerabilities in the system," the FBI report said. "During declining markets, mortgage fraud perpetrators may take advantage of industry personnel attempting to generate loans to maintain current standards of living."

The news about mortgage fraud, then, is mixed. Some scammers who successfully manipulated loan procedures during the real estate boom years are getting out of the trade, unsure how their tactics can work in a shrinking economy and intimidated by the prospect of long prison sentences.



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"The FBI's warnings have been very stern," Lackner says. "I think they did scare lots of people."

Even small-time scammers are nervous. "I'm getting a lot of calls from people who say, 'I overstated my income three years ago to get a loan, am I gonna go to jail?'" Novy says.

The answer is probably not. In its April report, the FBI said it would focus its enforcement efforts on people who committed mortgage fraud for profit, often involving multiple houses, instead of people who committed fraud to buy their own home.

But there is still so much profit to be made, are so many homeowners facing foreclosure, so many new scams to try, and so many lenders desperate to make a quarterly profit that temptation remains high.

And there are still so few police on the scene.

"Regulators are completely overwhelmed," says Strupp. "They simply can't keep up."

Which means that the mortgage fraud crisis is not over. It will decrease in some areas and change shape in others.

"The bad guys are using more sophisticated techniques, but it's always the same fraud: writing false statements on documents to get a loan they shouldn't be able to get," Morgan says. But experts agree that there will be millions more properties like Unit 602 that mysteriously rise and plummet in value, wreaking havoc on the neighbors and entire communities.

"The people involved in the [Unit 602] scam are out of business," Lackner says. "But new people are coming up to take their place." ■

Frauds Begin to Get their Due

Though it was slow in coming, the FBI's crackdown on mortgage fraud is beginning to net serious results. In October, Joseph Sterling Jetton, a home builder and realtor in Woodstock, Ga., was sentenced to 14 years in prison and ordered to pay \$11.2 million in fines for his role as the mastermind of a sophisticated mortgage fraud scheme, according to the U.S. Department of Justice.

An FBI investigation proved that Jetton recruited straw buyers to purchase homes at fraudulently inflated prices, paying the buyers up to \$600,000 apiece and claiming over \$1 million for himself in commissions alone.

All told, Jetton managed to steal \$19 million from lenders, according to the Justice Department. Nearly a dozen other members of the scheme also have been found guilty, including two other leaders who face years in prison and millions in fines.

Observers hope that investigations like these, which bring down an entire criminal syndicate and force the leaders to face heavy punishment, will deter future mortgage fraud.

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AN INDUSTRY PERSPECTIVE

Guest editorial by **Randy Johnson**

The courts have already found mortgage industry executives guilty of various crimes. Others are still under investigation. But let's not forget that major institutions played a hand in the subprime mortgage meltdown. It is pretty obvious that lenders, including some of the nation's largest banks, either failed to adequately supervise their personnel or consciously abetted a pattern of deception that ultimately resulted in losses by loosening up underwriting standards and safeguards intended to detect fraudulent transactions. Management's key job is to set the quality standards and see to it that they are heeded by employees. The failure to do so, which is now very obvious, makes many of the nation's top financial managers culpable.

The atmosphere on Wall Street also contributed to the ever-escalating problems. Those involved in the processing of the purchase and sale of pools of mortgages ignored the obvious deterioration of loan quality and continued to peddle ill-conceived loans to their clients. That's fraud in my book. Even worse, the rating agencies lost their objectivity. Institutions like Moody's Investors Service, Standard & Poor's, and Fitch Ratings were getting paid to check the quality of the loans and rate the portfolios, a system that was riddled with problems.

First, the rating agencies were paid by the issuer of the securities backed by the loans—a common practice, yet one that created a conflict of interest given that agencies' future business was contingent upon favorable ratings.

If an agency gave a stellar rating to a pool of mortgages that should have been rated lower, can that be considered fraud? Any buyer of a mortgage pool who suffered a loss because he or she relied on that rating would probably say so. One mistake is forgivable, but when mistakes become a continuing pattern you begin to wonder. If the ratings process was instead financed by the buyers, the entities that would ultimately assume mortgage risk, the conflict of interest could have been averted.

Financial institutions themselves have also been affected now that the system has collapsed onto itself. Having been

forced to downgrade securities ratings, they've been forced to swallow the losses incurred as a result of these "marked down" prices.

Now let's talk about where the rubber meets the road: the interaction between the borrower and his or her real estate agent. It is clear that buyers had a lot of smoke blown at them regarding the likelihood of an increase in property values when there was no guarantee of future appreciation. Buyers who had seen their friends' homes increase markedly in value wanted to participate. And here was their agent telling them, "You don't have to work hard to get rich. You don't have to take risk to get rich. This is risk-free."

Unfortunately this type of sales pitch only works when values really are increasing. As we have seen this year, values have plummeted in many markets so the get-rich-quick pitch no longer works.

The willingness to believe that you can get rich quick is not new. We can track this same behavior over our country's history. Consider the gold rush of 1849. How many people left their homes and headed to California thinking they would find gold just laying around? I know at least two: my great-great grandfather and his brother.

In the Roaring Twenties, everyone bought into the stock market, and the crash of the market led to the Great Depression. Similarly, the euphoria that surrounded the high-tech industry and its dot-com sidekick convinced millions of people that they could

get rich quickly and easily. Of course, the hangover from the ultimate crash and the ultra-low interest rates that followed probably contributed greatly to the real estate bubble and the credit crisis.

My point here is that at certain times ordinary people throw caution to the wind and get sucked into deals by trickster salespeople who prey on suckers, trying to defraud them.

Of course, many of these same potential homebuyers had been unable to get a loan previously because of poor credit, lack of a down payment, lack of sufficient income, or a combination of these factors. The loan officer asked about income and they said, "\$3,000 per month." And the loan officer said, "That's not enough to qualify." At that point, most of the buyers who now find themselves in trouble told a fib and their loan became what is known in the industry as a "liar loan."

It's simple: Making statements that are untrue in order to induce someone to give you money constitutes fraud. In the case of the aforementioned loan application, it is especially serious because the statement was made under penalty of perjury. Yes, folks, it does say that on the application just above the signature.

Perhaps the saddest form of mortgage-related fraud is the manner in which toxic subprime loans were described to the borrowers. You would never know these loans were dangerous by the way

some loan officers explained them. Buyers are supposed to get a thorough disclosure about terms and conditions. These include information on potential changes to rate and payment, on pre-payment penalties that might make it impossible to refinance, and more. They describe when changes to the rate and payment would occur; the limits, if any, on those changes; and factors like pre-payment penalties that would make it impossible to refinance. To get customers to agree to these dangerous loans, it was necessary to conceal those terms. Those loan officers were defrauding their clients and those toxic loans are the proximate cause of many foreclosures.

There could have been safeguards against this type of fraud. There are a number of regulatory bodies that are supposed to look out for consumers and other agencies that are supposed to monitor companies at every level of the process. All of them were asleep at the switch. As we have seen,

companies engaged in widespread fraud and no one did anything. Today, of course, the investigators are wandering through the rubble trying to find someone to prosecute, but this is a couple of years after they should have acted. It's too late. The damage is done.

We now see the consequences of that web of deceit that permeated every step in the process. What most interests me is that it never would have happened if there had been just one simple ingredient: buyer education.

People spend more time figuring out what flat-screen TV to buy than they do in learning about the very complex process of buying and financing a home. Had several million buyers been educated about the process, they would have seen the pitfalls and dangers in the transaction they contemplated. They would have seen the potential danger in the toxic loans they signed up for—many of the

transactions that are today ending in foreclosure would never have occurred.

So this is a fine place to end our sortie into the land of subprime aftermath. This national crisis cries out for homebuyer education but it isn't coming out of Washington D.C. Those people purporting to clean up the mess seem to be more interested in publicity and no one is saying a word about an education program to prevent it from happening all over again. You may know someone who has been damaged. I hope that this inspires you—that you make a commitment to your personal education and that you urge everyone you know to do so as well. ■

Randy Johnson is the mortgage expert for Credit.com. He is the author of "How to Save Thousands of Dollars on your Home Mortgage" and is a mortgage broker who has financed over \$1 billion in properties.

Home equity loans: easy target

For home owners, a Home Equity Line of Credit (HELOC) is a simple way to finance renovation projects. But according to the FBI, the credit lines also are perfect tools for identity thieves. With little more documentation than it takes to acquire a credit card, an identity thief posing as a bank customer can open a line of credit.

Unlike credit cards companies, however, banks financing HELOCs don't mail out monthly statements. And consumers usually only check these accounts when they're about to make a purchase, according to the FBI. That makes it incredibly easy for identity thieves to drain money from an existing account, or to create a line of credit in someone else's name.

"A home equity line of credit is an ideal target for identity thieves because it's often big dollars, and if consumers are not using the account, they may not check the balance," Anne Wallace, president of the Identity Theft Assistance Center, said in a press release in response to the FBI report.

How should consumers obtaining Home Equity Lines of Credit protect themselves against fraud? The FBI suggests checking account balances each month for any signs of identity theft. If you're a victim, visit www.identitytheft911.org, click on "If Your a Victim", and follow these tips to help reclaim your identity.