

MORTGAGE FRAUD

Fighting Back with Prevention and Detection

Mortgage Matters is a monthly column by real estate attorney Joanne S. Liu

Mortgage fraud is the country's fastest growing white-collar crime, striking unsuspecting lenders everywhere and especially in hotspots such as Georgia, Florida, Missouri, Texas, California, and Nevada. In the past three years, mortgage fraud has grown at a rate of 140 percent per year, costing lenders and borrowers from \$1 billion to \$3 billion annually. One out of 250 mortgage loans contains some element of fraud that will result in financial loss to the lender. And the FBI has witnessed a quadrupling in reported cases from 4,225 to almost 22,000 from 2001 to 2005. Chances are your credit union has already been the victim of fraudulent loans, and the failure to acknowledge its impact is no longer an option, lest you don't mind handing over large sums of money to perpetrators.

Rachel Dollar, attorney and publisher of the Mortgage Fraud Blog (www.MortgageFraudBlog.com) can attest to mortgage fraud's increased visibility. When she first introduced her mortgage fraud blog in July 2004, she occasionally posted news about mortgage fraud cases, including convictions of perpetrators. A little over two years later, mortgage-fraud news emerges virtually every day, and it's only worsening.

With the cooling of the real estate market comes increased awareness of the presence of mortgage fraud. Tim Grace, chief executive officer of BasePoint Analytics, a provider of fraud software for the mortgage industry, says, "Mortgage fraud has always been present. In recent months, it's become more noticeable and more present due to the decline of loan applications that lenders have seen." Grace explains that many industry insiders who benefited financially from the high volume of real estate transactions in recent years are faced with a sudden decline in business. They've grown accustomed to living a certain lifestyle, and the desire to maintain that elevated standard encourages unscrupulous behavior.

"When volume starts to diminish, they act in desperate ways," he adds.

The FBI defines mortgage fraud as "a material misstatement, misrepresentation, or omission relied upon by an underwriter or lender to fund, purchase, or insure a loan." The majority of mortgage fraud is perpetrated by individuals who work for lenders. Known as "fraud for profit," the industry professionals committing mortgage fraud make up 80 percent of all existing cases. Dollar, who represents lenders in mortgage-fraud cases, says that industry-insider fraud is usually perpetrated by mortgage brokers and appraisers, and less so by in-house employees. "If it's in-house, then it's at a higher level, usually an account executive," she says.

These industry insiders – mortgage brokers, appraisers, in-house loan agents, and other mortgage professionals – concoct endless variations of schemes: flipping, equity skimming, inflated appraisals, false statements on loan applications, fake supporting loan documents, cash kickbacks, and more. Whatever the means, mortgage fraud constantly evolves. "Every time a lender makes a change, the fraudsters adjust to it and exploit it," says Dollar. "They're poking at the lender's defenses."

To better protect themselves, lenders have realized the need to take aggressive measures to prevent fraud in their own operations, for despite the overwhelming increase in mortgage fraud reports, the FBI retains only 100 agents to deal with the crime. Grace says, "In the last couple of years, mortgage lenders are taking a more proactive stance and using more advanced solutions. They're weeding out fraud before funding; they need to work more efficiently."

Dollar says it's important for lenders to do their due diligence and carry out spot checks. "Maintain a level of review for all levels of employees," she says. "Don't let them go out there without supervision." In addition

to quality control reviews, monitoring third-party activities and maintaining an eligibility list, Dollar recommends checking the Mortgage Asset Research Institute's system, which maintains a database where lenders report incidents of fraud, to ensure the third parties they work with haven't already defrauded another lender. This is especially relevant considering that fraudulent mortgage brokers often use a hit and run tactic – they submit loans to one lender in high volumes in a short amount of time and then move on before they arouse suspicion.

To assess their positions, lenders must first understand their fraud-loss rate. Grace says, "Go through a measure of fraud rate on a month-to-month basis for the last 12 months." Though this may entail some work, lenders need to understand their positions. Loans that go into foreclosure are often marked as a loss, but the loss is not attributed to fraud.

In addition to identifying foreclosed loans linked to mortgage fraud, lenders should also track loans that were declined because they were identified as fraudulent. By marking these loans, statisticians can create a more effective model for future detection of fraudulent loans.

Grace says that lenders should also create a strategy and organization for managing fraud risk, which may take different forms. For lenders using his company's software, FraudMark, which allows lenders to electronically assess loan applications, Grace says, "You might have a central group reviewing the top 10 percent of loans from FraudMark. One way or another, there should be a group reviewing loans referred to them by an underwriter or as a result of software like FraudMark."

Grace also recommends that lenders take other precautionary measures, including maintaining a broker "watch list," conducting rigorous performance evaluations and testing false-positives. William S. Smith, general counsel of Option One Mortgage Corporation, who also encourages lenders to maintain a broker "watch list," suggests increasing scrutiny of loans from these brokers and reviewing sample loans marked for high risk. In addition, employees involved in originating loans should receive training to raise their level of awareness.

Another precautionary measure for lenders, one that Dollar recommends, is the use of pre-funding mortgage fraud software products. "Instead of having to go over 100 loans with a fine tooth comb, these products identify loans based on red flags in a customized way," she says. Interthinx, which sponsors Dollar's Web site, is one such company that enables lenders to measure and reduce mortgage-fraud risk.

Mortgage-fraud software, such as BasePoint Analytics's BrokerWatch and FraudMark, allow lenders to identify high-risk loans. "Our flagship product, FraudMark, is an analytical scoring product that uses pattern-recognition techniques," says Grace. "It looks at historical loans and uses those to learn the characteristics of good and bad loans." FraudMark applies a score (from 1 to 999) to each loan to indicate its risk of mortgage fraud – the higher the score, the higher the risk. Through the

first half of 2006, lenders' implementation of FraudMark into their systems prevented the funding of more than \$300 million of suspicious loans.

BrokerWatch

specifically targets mortgage brokers, and for good reason. "We have found that the majority of fraud can be captured by looking at the top riskiest brokers in [a lender's] portfolio," says Grace. The software analyzes each broker who submits loans to the lender and provides a risk-based score for that broker. According to Grace, BrokerWatch, which was released in August 2006, has already enabled one lender to identify two uses of mortgage fraud within the first two weeks of use.

Lenders taking measures against mortgage fraud can prevent the disappearance of millions of dollars from their pockets. By exercising vigilance and incorporating precautionary measures, they can narrow their doors to risk, ward off fraudsters looking for the easiest targets and, ultimately, carry a more robust portfolio of loans.

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Joanne S. Liu, a former real estate attorney, covers legal, historical and business topics for a variety of publications. You can learn more about Joanne on her Web site at www.JoanneLiu.com.

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