

## Protecting Wholesalers from Fraud

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When you see a termite gnawing at a floor joist in your home, do you assume it is on a solitary sortie and will cause no harm? No: You call an exterminator. You act immediately to find and kill every bug on your property and to install barriers against future penetration. While the individual pests are tiny, you realize that colonies of their kind can inflict incredible damage and down the grandest of structures by eating away at their foundations.

Discovery of a single fraudulent loan in a mortgage portfolio should strike equal fear in the hearts of primary and secondary mortgage market participants. If it appears that one mortgage application has been doctored, it is probable that others climbed through the same loopholes. What's more, people who conspire to commit fraud for profit do not enter the game merely to steer one bad loan through a complex system. Rather, their procedures are honed to mass-produce loans that will line their pockets again and again.

Mortgage fraud is frightening because it has the potential to weaken and even fell afflicted financial institutions. Direct monetary losses may spring from bad loan write-offs, government fines and lawsuits. Damage to a reputation may be more costly, subjecting institutions to long-term scrutiny by regulators and causing former business partners to shun them. Investors also may dump their stock.

Consider the \$7 million toll First Union Mortgage Corporation, a subsidiary of Charlotte, North Carolina-based First Union Corporation, recently paid the U.S. government to settle a lawsuit. The suit was filed under the False Claims Act involving HUD's Single Family Mortgage Insurance Program. The lawsuit claimed the subsidiary (then Cameron-Brown Mortgage Company) represented that borrowers made down payments on properties, when these funds actually were repocketed by the buyers at closing. The lawsuit also alleged that "straw buyers" were paid to apply for loans that were "flipped" back to the real purchaser after closing.

However, the fate of Cityscape Financial Corporation, Elmsford, New York, a player in the subprime home-equity market in the United States and the United Kingdom, is much worse. Cityscape admitted that it found mortgage fraud in a \$130 million portfolio bought from a New Jersey source. Around the same period, the press noted that two individuals formerly associated with firms that had unsavory reputations now headed businesses that served Cityscape as major loan suppliers. Such woes put the operating license for the firm's British subsidiary in jeopardy and sparked threats of a class-action suit by borrowers. Next, Moody's twice downgraded the company's senior debt. In a year's time, prompted further by deteriorating business conditions, the price commanded

by Cityscape stock plummeted to one-third of its value at its zenith. In October 1998, Cityscape filed for Chapter 11 bankruptcy.

Whatever the facts behind Cityscape's fall from grace or First Union's settlement, their pain should encourage all mortgage market participants to be vigilant. This caution applies doubly to wholesalers, who are uniquely vulnerable to infections through loan transfusions from unfamiliar donors. Too often wholesalers submit to unrealistic time pressures. They simply hope quality will be there as deals involving fantastic loan volumes funnel through the market's pipeline.

Mortgage originations have virtually doubled since 1990, and in early 1998, Freddie Mac chairman and CEO Leland C. Brendsel stated that total residential mortgage debt stood at an all-time high of \$4 trillion. This expansion has been fueled by exponential growth in the secondary mortgage market. For example, between 1996 and 1997, the issuance of mortgage-backed securities jumped 75 percent. In 1997, Freddie Mac alone purchased about \$230 billion in mortgages.

There is every indication that mortgage fraud is increasing at the same dizzying rate as the overall originations market. The FBI and industry sources estimate that 10 percent of all loan applications contain material misrepresentations, while about 13 percent of the credit losses suffered by federal financial institutions are tied to mortgage loan fraud. According to one report based on FBI numbers, institutions may annually process up to \$60 billion in fraudulent loans with losses approaching \$30 billion.

Given this magnitude, aggressive industry measures are required to prevent fraud and ensure due diligence is exercised. Lenders-even wholesalers-can protect themselves. Moreover, if you suspect fraud has already taken place, you should consider engaging professionals with multidisciplinary skills to conduct an immediate internal inquiry. Your goals should be to assess the extent of the problem and all legal (civil and criminal) consequences; determine the best course of action to minimize institutional and regulatory liability; develop strategies to correct deficiencies; and quickly and completely advise regulators of the situation so you can move forward in an atmosphere of trust and cooperation.

### **Fraud for housing, fraud for profit**

Mortgage fraud occurs when a financial institution relies upon a material misstatement or omission to fund, purchase or insure a loan. To prevent mortgage loan fraud from infiltrating their business, industry participants should fully understand its variants, the identity of potential "fraudsters" and their modus operandi.

There are two major strains of mortgage fraud; fraud for housing and fraud for profit. Usually the fraud for housing goal is to put unqualified borrowers into homes. In such cases, applicants may be the sole culprits, misrepresenting their own down payments, income, debt levels or gift letters in order to qualify. If ultimate homeowners are the only participants, this type of fraud seldom represents a catastrophic business threat-though associated foreclosures can be costly.

However, insider collusion can greatly increase the institutional stakes. To pocket more loan origination fees, insiders may routinely encourage unqualified buyers to falsify information or even sign blank applications. When property values are escalating, insiders may view “looking the other way” as their opportunity to share in the wealth of a skyrocketing market. If the mortgages are backed by the government, they may believe that if any losses occur as a result of their prevarications, they will be borne by faceless entities that will never notice. Yet, if the real estate bubble bursts-as it did in the 1980s when the house of cards collapsed for ComFed Savings Bank-foreclosures can create a domino effect that shakes the entire market.

A subquality lending atmosphere also puts out a fraud-for-profit welcome mat. For example, insiders may induce borrowers to commit fraud so they can obtain kickbacks and/or claim fees on unnecessary services-a practice called loan packing. In addition, greedy insiders may prey on naïve or elderly applicants. There are many documented cases of fraud rings that encourage financially strapped victims to obtain second mortgages to finance home improvements that never materialize. When the victims can't meet payments to cover usurious interest rates, the con team suggests refinancing of a primary mortgage as a way out. They then doctor documents so the applicants will qualify for larger mortgages. The fraud rings rake in a variety of fees and payments before foreclosures begin.

In another fraud-for-profit variant, real buyers don't exist. Rather, the borrowers are fictitious, or their identities are stolen along with supporting documentation. Individuals may be paid to stand in for the bogus buyers at closing. Or, in an alternate scenario, straw buyers may allow their actual names to be used for pay. Though the details vary, the goal is to buy properties at market prices, resell (or “flip”) them to phony buyers at inflated prices and obtain mortgages based on appraisals that are multiples of true resale values. Often insiders manage the properties as residential rentals and deftly maneuver to keep them out of default until the loans are closed and sold in the secondary market.

Industry insiders almost always feature prominently in land-flip plots, which may script roles for any or all professionals involved in the transaction-the broker, banker, appraiser, title company, accountant and attorney. (During 1997, the FBI calculated that 29 percent of the 2,551 individuals convicted in financial institution fraud cases were bank employees or officers.)

Multiple conspirators recognize that their collusion will make it difficult to make a case against any one individual, since the deception is complex and the ability to fingerprint is almost endless. When the fraud is crafted in whole cloth by the loan originator, the fiction often looks quite genuine and detection is difficult for an unsuspecting wholesaler.

In 1996, the FBI uncovered an eight-person land-flip ring that had bilked \$6 million from four banks before someone noticed that a number of problem loans featured identical names. That same year, a single mortgage broker originated and sold straw-buyer/land-

flip mortgages to more than 10 lenders, supplying falsified tax returns, credit reports, verifications of employment (VOE) and verifications of deposit (VOD).

In late 1997, the FBI issued indictments related to a California “mortgage mill” bonanza that generated \$60 million in fraudulent federally insured loans. Occasionally fraudsters are brazen enough to sell nonexistent properties so they can pocket not only origination and servicing fees but all loan proceeds.

### **When red flags wave**

Such examples illustrate the importance of taking immediate action if a problem arises. Ignorance is definitely no bliss, and paying a seasoned professional with proven industry credentials to probe the source and scope of potential fraud may prove a shrewd investment. In fact, swift coordinated action on legal, investigative, regulatory and even public relations fronts may be the only recourse to save your business from the threat of fraud.

Because mortgage fraud begins at the application process, a historical analysis of loan documentation is the logical starting point when one or more troublesome defaults raise a red flag.

The inquiry process is similar for institutions that originate loans and wholesalers that acquire them from brokers or bankers down the chain. To begin, select a representative sampling of loans in the suspect portfolio. Since the national default average lies between 3 and 8 percent, a 10 percent sample should be sufficient for initial analysis. The goal is to stress-test this sample to see if the verification process that should have been followed was actually performed. If an industry veteran performs this analysis, it may be possible for the person to quickly pinpoint insidious patterns. If the sample suggest problems but fails to connect all the dots in a fraud scheme, additional loans may then be analyzed.

Banks and wholesalers that buy loans from mortgage brokers and other institutions should verify that originators are following the strict documentation rules required to obtain federally insured loans. A “right to audit” for compliance might even be written into any agreement. Outlined below are basic fraud-prevention steps that should be incorporated into any protective plan:

- Ensure that the applicant is real. Get a valid identification at application, photocopy it and insist that the applicant produce identification at closing.
- Forbid employees from accepting applications signed while they are blank.
- Beware of phony gift letters. Always verify the gift source.
- Search for inconsistencies among documents. For example, does the income listed on the application match tax returns? This is particularly important for self-employed applicants.
- Have applicants complete an IRS Form 4506 Request for Copy or Transcript of Tax Form, which authorizes the IRS to release tax information to a third party.

Compare the information supplied by the IRS line by line with tax returns the applicants have submitted.

- Use resale comparables to ensure appraisals are in line for the area. Unusual appraisal values are a signature of classic land-flip schemes. In fact, while appraisals are seldom a first line of inquiry, they often represent a very fruitful one because inflated appraisals are relatively easy to detect. Wholesalers who don't have the advantage of a local lender's property knowledge can compare prices to recorded sales in the area or take advantage of automated valuation systems offered by a variety of technology vendors.
- Check to see if properties have been sold repeatedly in brief time spans. Fast, multiple turnovers often help ratchet up appraised values in land flips.
- Verify applicants' employment information. Follow-up phone calls provide inconclusive evidence, since fraudsters may arrange telephone answering set-ups to furnish phony information. If this is the case, added verification steps such as checking employers' phone book listings or their incorporation records with the secretary of state can halt the masquerade.
- Accept only original verifications of deposit with bank seals that have been sent directly from banks. Check for proof of mailing.

### **Technology aids due diligence**

Because crooks stay abreast of the latest technology, financial institutions, law enforcement professionals, investigators and counsel must do likewise. Documents that "look OK" can easily be computer-enhanced counterfeits or forgeries. In an era when top-notch scanners retail for a few hundred dollars and computer retouching is a routine skill, an absence of correction fluid does not rule out tampering.

One of the simplest ways to turn the technology tables on fraud perpetrators is to use various automation aids to help identify creditworthy borrowers from the outset. Automated loan evaluation services, such as Freddie Mac's Loan Prospector® and Fannie Mae's Desktop Underwriter®, may also add value by flagging potential problems. This can be especially helpful to wholesalers who buy in volume and face tight time constraints.

Many industry sources hope that increased reliance on automated underwriting technology and direct lender access to credit repositories and property-value databases will help unmask dishonest intermediaries in the loan process. A number of new databases are proving handy tools for individuals who know how to query these online resources. For example, employment salary, start date and other details can be verified through national employment databases. In a California plot, the IRS is even providing lenders with same-day answers to all faxed income-verification requests.

### **Background checks**

One of the best ways wholesalers can prevent fraudulent loans from invading portfolios is to make certain they deal with reputable mortgage brokers, bankers and correspondents. Always remember: If an associate presents you with a steady stream of lucrative business opportunities that seem too good to be true, they probably are.

Varied due diligence avenues are open to professionals who understand where to find profitable information veins for the financial industry and how to tap them as they investigate the backgrounds and practices of prospective business partners.

A thorough procedure for vetting applicants should use the skills of a number of specialists. For example, financial analysts should scrutinize any financial statements incorporated in the application, while experts in quality control should assess a prospective affiliate's lender and mortgage servicing practices. A companion background check should examine the lending institution or broker organization and key personnel.

This background probe should include searches of national fraud repositories to determine if the principals are linked to any present or past fraud activity, misrepresentations, license suspensions, revocations or other problems. In addition, courthouse records should be physically searched and law enforcement organizations contacted for leads on suspicious activities.

Institutions that do business with Freddie Mac also are required to screen their business contacts to make sure their names do not appear on its list of "excluded" operatives. This list is made up of individuals and institutions banned from origination or loan servicing participation as a result of breaches of integrity or evidence of incompetence.

At the state level, departments of banking or real estate should be contacted to ensure prospective banks or brokers are licensed and to review any complaints that have been filed against them. (Not all states require broker licensing.) However, while state resources can provide invaluable information, they may have no knowledge or record of arrests or even convictions that occurred in other states.

Of course, initial approval of a business partner should be the beginning of a quality assurance process, not the end. Wholesalers must remain proactive in monitoring broker standards and making certain they verify tax information.

### **Market pressures and the future**

Many of the worst fraud-related mistakes wholesale lenders make happen as a result of time pressure. Decision makers up the line issue an edict that 10,000 loans should be added to a portfolio post-haste. Then sheer numbers become the quest in this huge origination market, and the proper insistence on quality is abandoned.

Just as the scent of big money prompts some wholesalers to not be as vigilant as they should the aroma attracts criminals like an aphrodisiac. This reality makes the eradication of mortgage fraud an unrealistic goal. However, it is essential for the industry to keep mortgage fraud in check. If fraud leads to excessive loan defaults and mammoth financial losses, the effectiveness of our entire mortgage funding system could be jeopardized.

Unfortunately, it takes only a modicum of imagination to create a variety of disastrous plots that could be triggered by one massive occurrence of fraud. Consider what might happen if a multibillion-dollar hedge fund suddenly found its huge portfolio of mortgage-backed securities was filled with bad paper. If it could not absorb the losses, the federal government and ultimately taxpayers might be forced into a bailout, or the fund's failure could launch a destructive tsunami that drowns the economy.

Four industry trends are conspiring to make institutions more susceptible to fraud-related financial woes: industry consolidation, competitive pressures to reduce underwriting standards, a tightening of U.S. economy and the globalization of financial markets.

Bank megamergers and service diversification efforts have created a number of superbanks. In fact, many analysts feel a trillion-dollar U.S. Bank is just around the corner. The continuing acquisition frenzy has prompted many institutions to acquire mortgage banks-sometimes without benefit of proper due diligence. Already, some institutions have realized new mortgage banking acquisitions may come with unexpected baggage ranging from overstated profits to hidden histories of fraud that can damage corporate identities and translate into large legal liabilities.

At the same time, increased competition may be encouraging some lenders to lower their underwriting standards to meet asset or fee-income growth goals set by management. Unfortunately, not all lenders choose to remember the painful lessons of recent decades when all too many S&Ls and banks succumbed as real estate prices plummeted and foreclosures became routine.

There are many signs that the U.S. economy has begun to tighten. While the down cycle may not happen today or next month, a retrenchment is inevitable. When that happens, instances of fraud will exacerbate the foreclosure problems that U.S. institutions are certain to face.

Additionally, financial markets are becoming increasingly global. Many U.S. financial institutions have foreign operations and major cross-border investments. When aftershocks from the Asian financial crisis die down, global funds are likely to rebound in popularity. This could usher in new generations of securities backed by mortgages of mixed national parentage. Such a development could expose large financial institutions to significant risk from "imported" fraud. Loans gone bad as a result of fraud and corruption played a key role in the Asian currency and subsequent banking crisis.

However, institutions that act to rid existing portfolios of fraud and adopt preventive measures to inoculate against future invasions from domestic or foreign sources can position themselves to survive such challenges and win a competitive edge.