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Mortgage Fraud Challenges: How to Catch a Crook

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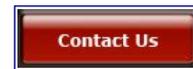
Chairman & Managing Director

Two of our Directors will be attending the MBA's "Risk Management, QA & Fraud Prevention Forum," held in Los Angeles, in September. Attending this venue will be Brandy George, who is the Executive Director of LCG Quality Control and Michael Pfeifer, who is a Director of Legal and Regulatory Compliance. I remember attending the first forum many years ago. The attendance was modest. Although risk management was strengthening, I felt the term risk management was much too broad, as it could be (and was) applied to many industries. So, I coined the term "Mortgage Risk Management" and it caught on! My view has been that mortgage banking poses a unique set of risks that require significant knowledge, experience, and expertise. Turns out, this insight has been reinforced over the years. Now, this event is highly attended and is brimming with new ways to handle quality assurance, mortgage fraud prevention, and risk management oversight.

As I contemplated this forthcoming conference, I thought of the difficulties that mortgage originators have in handling the challenges of mortgage fraud in particular. This is a nasty business and not for the faint hearted! When my firm conducts audits of the loan flow process, it is not unusual to find gaps – perhaps 'chasms' is a better word! – in a company's procedures for managing mortgage fraud risk. It still surprises me, after so many decades in mortgage banking compliance and financial institution management, that the fraudsters seem to have no limit to their scheming, conniving, crafty, wily, and underhanded cunning. These guys are as slippery as a darkly oleaginous grease slick.

Maybe I can't stop these swindlers and shysters from doing what they do, but I can let you know some of the lessons my firm, Lenders Compliance Group®, has learned in knowing how to identify and trap them. I may not have all the answers, but I sure do have a lot of experience in hooking the crook. So, come with me on a brief walk through the mortgage fraud maze, as I jot down some of my reflections, and perhaps you should consider using

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- ▶ 2010 (86)
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SUITE OF SERVICES



some of my ideas to fine-tune your own mortgage fraud prevention procedures.

Let's start with a simple outline of what fraudsters do!

COMMITTING FRAUD

During the mortgage lending process, a fraudster is a person who knowingly does any of the following:

- Makes, uses, or facilitates any deliberate misstatement, misrepresentation, or omission with the intention that it be relied upon by a mortgage lender, borrower, or any other party to the mortgage lending process;
- Receives any proceeds or any other funds in connection with a closing involving mortgage fraud; or
- Files or causes to be filed with the county recorder, any document that contains a deliberate misstatement, misrepresentation, or omission.

In my view, there are two types of mortgage fraud: the first is fraud for property, and the second is fraud for profit.

The first type is where fraud occurs for property (i.e., housing) and usually entails some kind of misrepresentations (for instance, employment history, claimed income) by the applicant solely to purchase property for a primary residence, generally. Schemes usually involve a single loan. Although applicants may embellish income and conceal debt, their intent is to repay the loan.

The second type is even more pernicious. Fraud for profit causes much concern to law enforcement and the mortgage industry. Often, this type of fraud involves multiple loans and elaborate schemes to gain illicit proceeds from property sales. Gross misrepresentations of appraisals and loan documents are most common, and loan applicants are frequently paid for their participation.

You may not like to read this, but FinCEN long ago reported that perpetrators are often industry professionals who are familiar with the mortgage loan process and know how to exploit vulnerabilities in the system. These professionals can include accountants, mortgage brokers and lenders. When my firm conducts audits, we do not assume that the fraudsters are only external actors. Unfortunately, there are numerous instances of internal actors who know how to game the procedures, often leading to injurious outcomes. To commit fraud, industry professionals often misrepresent factors in multiple loan transactions, such as borrower income, debt, assets, and employment.

Indeed, fraud for profit often impacts more than one financial institution and involves co-conspirators who corroborate fabricated information. Think of such examples as documenting their misrepresentations through inflated appraisals and inaccurate employment histories.

Here is a very brief list of malevolent stratagems that fraudsters employ to carry out their schemes:

- False claims

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- Omission of information
- Inflated credit scores (authorized user scam)
- Fraudulent warranty deeds
- Fraudulent quitclaim deeds
- Falsified tax returns
- Bogus bank statements
- Phony company
- Collusion
- Pyramiding to conceal misappropriation
- Rented assets
- Purchased false documentation
- Mortgage loan from another lender or seller held second
- Limited verification programs (NIV, No Ratio, NINA, No Doc)

REPORTING FRAUD

So, what do you do if you catch a crook?

Mortgage fraud is investigated by the Federal Bureau of Investigation and can be punishable by up to 30 years in federal prison or \$1,000,000 fine, or both. It is illegal for a person to make any false statement regarding income, assets, debt, or matters of identification, or to willfully overvalue any land or property in a loan and credit application, for the purpose of influencing in any way the action of a financial institution.

There are specific statutes that get triggered. Applicable federal criminal statutes include:

- Statements or entries generally:[1]
- HUD and Federal Housing Administration transactions:[2]
- Loan and credit applications, generally:[3]
- Fraud and related activity in connection with identification documents:[4]
- Frauds and swindles by mail:[5]
- Fictitious name or address:[6]
- Fraud by wire:[7]
- Bank fraud:[8] and,
- False social security number.[9]

When mortgage fraud is suspected, criminal charges can include identity theft, grand theft, wire fraud, money laundering, and forgery, to name a few, each of which carries its own brand of civil monetary and criminal penalties. Because of the growth in mortgage fraud, some states have moved to establish their own mortgage fraud laws. To pick but one, the Georgia Residential Mortgage Fraud Act, for instance, provides a definition of residential mortgage fraud and outlines terms of punishment for violation of the law.[10]

This state law amends the Georgia Racketeer Influenced and Corrupt Organizations Act (RICO) to include residential mortgage fraud within the definition of racketeering activity. Under the statute, the crime of residential mortgage fraud is committed when people make deliberate misstatements or omissions during the mortgage lending process, with the intention that it will be relied on or, if they receive proceeds from a closing that they knew resulted from these types of omissions or lies.

The Georgia law provides for felony penalties of 1 to 10 years in jail and/or a \$5,000 fine. If a pattern of fraud is found, the penalties become 3 to 20 years

in jail and/or a fine of \$100,000. The law also provides that property that comes under the bill's provisions is subject to forfeiture.

Some states are following Georgia's example, while others are working on variations of what Georgia enacted.

Some of these variations, nevertheless, set forth some common features, such as:

- Requiring a person convicted of mortgage fraud to pay restitution to the victim,
- Creating a mortgage lending fraud protection fund,
- Requiring the Attorney General to develop mortgage fraud prosecution guidelines,
- Creating optional disclosures to borrowers and third parties (i.e., stating mortgage fraud is a criminal offense)
- Incorporating mortgage fraud into existing criminal or civil statutes,
- Narrowing mortgage fraud to apply only to certain mortgage professionals or acts, and
- Creating new investigatory and enforcement provisions.

It is worth noting that the MBA has gone on record saying that individual state mortgage fraud laws may make prosecution more difficult until sufficient case law is available for attorneys and judges under the new provisions. The view is that existing federal laws have been used to successfully prosecute mortgage fraud cases. Furthermore, it is also argued some states that allow private right of action against mortgage fraud perpetrators may create frivolous lawsuits without producing material reduction in mortgage fraud. I'm not so sure I agree with this view. After all, state banking departments have a legal obligation to exam their licensees for the purpose of protecting the consumer. In their role as consumer protection and advocacy agencies, state banking departments recognize that mortgage fraud is one of the most devastating plagues affecting individuals and entire communities. Although litigation has been building, it's hard to tell when there will be case law to prevail in the prosecution of mortgage fraud. Meanwhile, the fraudsters keep spinning their yarn!

SOLVING FRAUD

I do not think mortgage fraud is going away! Then again, neither is thunderstorms. But that doesn't mean we should ignore taking an umbrella when a storm is on the way! Therefore, I am going to spend the rest of this article discussion solutions to reducing mortgage fraud. Emphasis will be placed on identifying and reducing fraud.

I believe there are three primary solutions to preventing mortgage fraud. When we do our audits, sometimes I see the outcome of poorly written or improperly implemented procedures in the loan flow process. I say to myself, "If only they had done this," or "If only they had done that!" The issues always seem to come down to having solutions that are time-tested.

The three solutions are:

1. Expanding the underwriting process,
2. Considering predictive models that reject loans in pre-funding, and
3. Implementing Red Flag training, fraud prevention control reviews, and fraud detection questionnaires.

I supposed the first two are somewhat obvious.

The underwriting process should include:

- Authenticating and verifying all documents;
- Using notaries for signatures;
- Confirming values;
- Confirming appraiser identities;

- Confirming real estate; and
- Verify almost everything.

Predictive models are relatively new in the mortgage field. There are models that can predict if a lender's pre-funded loans, if booked, would stop paying within the first six months. Some analytics can show that mortgage early payment defaults can be linked to a significant misrepresentation on the original loan application, such as:

- Income inflated by a significant percent;
- Appraisals overvaluing the property by an excessive percent; and
- Fictitious employers and/or falsified tax returns.

On the obverse, there are models that show loans containing egregious misrepresentations were more likely to default in the first six months than loans - but did not.

The third solution – implementing Red Flag training, fraud prevention control reviews, and fraud detection questionnaires – is the “big bucket” solution. I am going to set forth an outline that could help you conceptualize the challenges involving mortgage fraud, as it relates to this third prong.

RED FLAGS

The term "Red Flags" is often associated with potentially suspicious activities for both money laundering and terrorist financing. Since mortgage fraud is a preferred means by which money laundering takes place, it is important to review the Red Flags list compiled by the Financial Crimes Enforcement Network (FinCEN).[11] Although these lists are not all-inclusive, they should be consulted and used as a way to remain sensitized to the ways that fraudsters use mortgage fraud for a host of illicit purposes, such as money laundering and terrorist financing schemes.

The Federal Trade Commission (FTC) has set forth its own Red Flags Rule[12] to help prevent identity theft. The FTC also provides a very helpful list. It provides twenty-six Red Flags in these five areas: (1) Alerts, Notifications or Warnings from a Consumer Reporting Agency; (2) Suspicious Documents; (3) Suspicious Personal Identifying Information; (4) Unusual Use of, or Suspicious Activity Related to, the Covered Account; and (5) Notice from Customers, Victims of Identity Theft, Law Enforcement Authorities, or Other Persons Regarding Possible Identity Theft in Connection With Covered Accounts Held by the Financial Institution or Creditor.[13]

Most important to mortgage fraud prevention is the use of Red Flags and controlling for them throughout the mortgage loan process. Lenders Compliance Group® believes controlling for a wide range of risks is so critical to a company's survival that we established a Director's position for it, which is held by Michelle Leigh, CRCM, Director of Regulatory Audits and Controls.

The following is a “checklist” approach that you can perform in the loan origination process. Many of these Red Flags come from many years of audits and due diligence reviews. You may need a firm such as Lenders Compliance Group® to conduct a comprehensive and independent audit; however, there really is no reason why you can't undertake many aspects of this kind of review on your own.

Where to begin? Applications!

Red Flags begin right at the point of sale, that is, when the loan application is taken. The mortgage application is the initial document completed by the borrower that provides the financial institution with comprehensive information concerning the borrower's identity, financial position and employment history.

Application Red Flags include the following:

- The application is unsigned or undated, or power of attorney is used.
- The borrower cannot execute documents — investigate if formal supporting documentation exists.
- Signatures on credit documents are illegible and no supporting identification exists.
- Price and date of purchase is not indicated.
- Borrower is selling his current residence but does not provide documents to support a sale.
- Down payment is not in cash (i.e., source of deposit is a promissory note or repayment of a personal loan).
- Borrower has high income with little or no personal property.
- Borrower's age is not consistent with the number of years of employment.
- Borrower has an unreasonable accumulation of assets compared to income or has a large amount of unsubstantiated assets.
- Borrower claims to have no debt.
- Borrower owns an excessive amount of real estate.
- New housing expense exceeds 150 percent of current housing expense.
- A post office box is the only indicated address for the borrower's employer.
- The same telephone number is used for the borrower's home and business.
- Application date and verification form dates are not consistent.
- Patterns or similarities are apparent from applications received from a specific seller or broker — certain brokers are unusually active in a soft real estate market.
- Concentration of loans to individuals related to a specific project is noted.
- Borrower does not guarantee the loan or will not sign in an individual capacity.
- Borrower's income is not consistent with job type.
- Employer is an unrealistic commuting distance from property.
- Years of education are not consistent with borrower's profession.
- Borrower is buying investment properties with no primary residence.
- Transaction resulted in a large cash-out refinance as a percent of the loan amount.

HOW TO AVOID APPLICATION FRAUD? TAKE CONTROL!

Controlling for application fraud includes the following actions:

- Establish an employee training program that provides instruction on understanding common mortgage fraud schemes and recognizing Red Flags.
- Conduct pre-funding reviews on new production.

- Closely monitor new brokers, correspondents, and products.
- Track performance using scorecard criteria. Typical tracking data includes:
 - Default rates,
 - Pre-purchase cycle times,
 - Loan quality indicators such as underwriting exceptions, and
 - Key data changes prior to approval.
- Verify the source of down payment funds by directly contacting the institution where funds are shown deposited.
- Closely analyze the borrower's financial information for unusual items or trends.
- Independently verify employment by researching the location and phone number of the business
- Employ pre-funding and post-closing reviews to detect any inconsistencies within the transaction.
- Conduct risk-based quality control audits prior to funding.
- Ensure that prior liens are immediately paid from new loan proceeds.
- Assess the volume of critical post-closing missing documents, determining the potential for repurchase recourse, and evaluating reserve adequacy.
- Monitor the real estate markets from the locale in which the institution's mortgage loans originated.
- Establish a periodic independent audit of mortgage loan operations.
- Provide fraud updates/alerts to employees.
- Review patterns on declined loans (i.e., individual social security number, appraiser, real estate agent, loan officer, broker, etc.).
- Establish a fraud hotline for anonymous fraud tips.
- Increase the use of original supporting documentation on third party transactions (i.e., wholesale and correspondent originations).

CHECK THE COLLATERAL FOR APPRAISAL FRAUD!

An appraisal is a written report that is supposed to be independently and impartially prepared by a qualified individual, stating an opinion of market value of a property as of a specific date. But fraudsters have found multiple ways to mess with appraisals.

Appraisal Red Flags include the following:

- The appraiser is a frequent or large volume borrower at the financial institution.
- The appraiser owns property in the project being appraised. This is a violation of the appraisal regulations and raises concerns about appraiser independence and bias.
- The most recent assessed tax value does not correlate with the appraisal's market value.
- The appraiser used is not on the institution's designated list of approved appraisers.
- The appraiser is from outside the area (and may not be familiar with local property values – understanding of local market nuances is critical to an accurate property valuation).
- An appraisal is ordered by a party to the transaction other than the financial institution, such as the buyer, seller, or broker.

- An appraisal is ordered before the sales contract is written.
- Certain information is left blank, such as the borrower, client, or occupant.
- The appraised value is contingent upon curing some property defects (i.e., drainage problems or a zoning change).
- Comparables are not verified as recorded, or are submitted by a potentially biased party, such as the seller or broker.
- Old comparables (usually 9 to 12 months old) are used in a “hot” market.
- Comparables are an excessive distance from the subject property or are not in the subject property’s general area.
- Comparables all contain similar value adjustments or are all adjusted in the same direction.
- All comparables are on properties appraised by the same appraiser.
- Unusual or too few comparables are used.
- Similar comparables are used across multiple transactions.
- Comparables and valuations are stretched to attain desired loan-to-value parameters.
- Excessive adjustments are made in an urban or suburban area, when the marketing time is less than six months.
- Appreciation is noted in a stable or in declining areas.
- Large unjustified valuation adjustments are shown.
- The land constitutes a large percentage of the value.
- The market approach greatly exceeds the replacement cost approach.
- Overall adjustments are in excess of 25 percent.
- Photos do not match the description of the property.
- Photos of comparables look familiar.
- Photos reveal items not disclosed in the appraisal, such as a commercial property next door, railroad tracks, etc.
- Items with the potential for negative valuation adjustments (i.e., power lines, railroad tracks, landfills) are avoided in appraisal photos.
- Loan amounts are disclosed to the appraiser.
- File documentation is inadequate to determine whether appraisals were properly scrutinized or supported by additional appraisal reviews.
- The appraisal fee is based on a percentage of the appraised value.
- Independent reviews of external fee appraisals are never conducted.
- One or more sales of the same property have occurred within a specified period (say, 6 to 12 months) and exceed certain value increases (usually 10 percent or more value increase).
- A fax of the appraisal is used in lieu of the original, containing signature and certification of appraiser.

CONTROLLING FOR APPRAISAL FRAUD

Amongst the most important appraisal controls, the following should be considered non-negotiable actions:

- Establishing an employee training program that provides a good overview of common mortgage fraud schemes, the appraisal regulation, the real-estate lending standards regulation, appraisal techniques, and Red Flag recognition

- Implementing a strong appraisal and evaluation compliance review process that is incorporated into the pre-funding quality assurance program.
- Ensuring reviewers identify violations of regulations and noncompliance with real estate lending standards and other interagency guidance.
- Establishing an approved appraiser list for use by retail, broker, and correspondent origination channels. This list should be generated and controlled by a unit independent of production.
- Obtaining a current copy of each appraiser's license or certificate.
- Implementing "watchlist" and monitoring systems for appraisers who exhibit suspect practices, issues, and values.
 - Note: include a post-closing review to detect any transaction inconsistencies.
- Establishing a "suspended" or "terminated" list of appraisers who have provided unreliable valuations or improper practices.
- Implementing controls to ensure that "terminated" appraisers are prohibited from engaging in future transactions with the financial institution, its brokers, and correspondents.
- Implementing third-party appraisal controls to ensure compliance with regulatory guidance, specifically as it applies to appraisals and evaluations ordered by loan brokers, correspondents, or other institutions.
- Developing appraisal requirements based on transaction risks.
- Statistically testing the appropriateness of appraisals obtained by brokers and correspondents by obtaining independent AVMs and appraisals.
- Establishing an independent appraisal review/collateral valuation unit to research valuation discrepancies and provide technical oversight.
- Reviewing the appraisal's three-year sales history to determine if land flips are occurring.
- Performing detailed research on each appraiser's business history and financial condition.
- Physically verifying the location and condition of selected subject properties and comparables.
- Monitoring real estate market values in areas that generate a high volume of mortgage loans and where concentrations exist.
- Employing pre- and post-closing quality control reviews to detect inconsistencies within the transaction and hold production units financially accountable for proper documentation and quality.
- Conducting periodic independent audits of mortgage loan operations.

CATCHING CREDIT REPORT FRAUD

A credit report is an evaluation of an individual's debt repayment history. But there are obvious and not-so-obvious Red Flags involving credit reports. To name a few, consider the following:

- The absence of a credit history can indicate the use of an alias and/or multiple social security numbers.
- A borrower recently paying all accounts in full (this can indicate an undisclosed consolidation loan).

- Indebtedness disclosed on the application differs from that in the credit report.
- The length of time items remain on file is inconsistent with the buyer's age.
- The borrower claims substantial income but only has credit experience with finance companies.
- All trade lines were opened at the same time with no explanation.
- A pattern of delinquencies exists that is inconsistent with the letter of explanation.
- Recent inquiries from other mortgage lenders are noted.
- AKA (also known as) or DBA (doing business as) are indicated.
- The borrower cannot be reached at his place of business.
- The financial institution cannot confirm the borrower's employment.
- Debt-to-Income (DTI) ratios are right at maximum approval limits.
- Employment information/history on the loan application is not consistent with the verification of employment form.
- Credit bureau alerts exist for social security number discrepancies, address mismatches, or fraud victim alerts.

CONTROLLING CREDIT REPORT FRAUD: COMMON SENSE TACTICS

Credit report controls must include the following actions and decisions.

- Establish an employee training program that provides instruction on understanding common mortgage fraud schemes, analyzing credit reports, and recognizing Red Flags.
- Include an analysis of the credit report in the pre-funding quality assurance program.
- Make direct inquiries to the borrower and creditors to get an explanation of unusual or inconsistent information.
- Obtain an updated credit report if the one received is older than six months.
- Independently verify employment by researching the location and phone number of business.
- Implement a post-closing review to detect any inconsistencies within the transaction.
- Establish a periodic independent audit of mortgage loan operations.
- Define DTI calculation criteria and conduct training to ensure consistency and data integrity.
- Clarify non-borrower spouse issues, such as community property issues and the impact of bankruptcy and debts on the borrower's repayment capacity.
- Ensure lease obligations are reflected in borrower debts and repayment capacity.
- Conduct real estate verification of credit to ensure accuracy of broker/correspondent provided credit reports.
- Obtain more than one report from multiple repositories available to corroborate the initial credit report if data appears questionable.

ESCROW AND CLOSING: WEAK LINKS IN FRAUD PREVENTION

A closing or settlement is the act of transferring ownership of a property from seller to buyer in accordance with the sales contract. Escrow is an agreement between two or more parties that requires certain instruments or property be placed with a third party for safekeeping, pending the fulfillment

or performance of a specific act or condition. This stage of the loan origination process is fraught with mortgage fraud calamities. Not every marker of fraud means fraud has happened; but almost every occurrence of fraud has a marker.

Consider these Red Flags as representative of an immense number of monstrous abuses.

- Related parties are involved in the transaction.
- The business entity acting as the seller may be controlled by or is related to the borrower.
- Right of assignment is included that may hide the borrower's actual identity.
- Power of attorney is used, and there is no documented explanation about why the borrower cannot execute documents.
- The buyer is required to use a specific broker or lender.
- The sale is subject to the seller acquiring title.
- The sales price is changed to "fit" the appraisal.
- No amendments are made to escrow.
- A house is purchased that is not subject to inspection.
- Unusual amendments are made to the original transaction.
- Cash is paid to the seller outside of an escrow arrangement.
- Cash proceeds are paid to the borrower in a purchase transaction.
- Zero funds are due from the buyer.
- Funds are paid to undisclosed third parties, indicating that there may be potential obligations by these parties.
- Odd amounts are paid as escrow deposits or down payment.
- Multiple mortgages are paid off.
- The terms of the closed mortgage differ from terms approved by the underwriter.
- Unusual credits or disbursements are shown on settlement statements.
- Discrepancies exist between the settlement statement and escrow instructions.
- A difference exists between sales price on the settlement and sales contract.

FENDING OFF ESCROW AND CLOSING FRAUD

Escrow and closing controls include the following actions:

- Establish an employee training program that provides an understanding of common mortgage fraud schemes, proper closing procedures, and recognizing Red Flags.
- Provide the closing agent with instructions specific to each mortgage transaction.
- Instruct the closing agent to accept certified funds only from the financial institution that is the verified depository.
- Require the closing agent to notify the financial institution if the agent has knowledge of a previous, concurrent, or subsequent transaction involving the borrower or the subject property.
- Obtain a specific transaction closing protection letter from the closing agent.
- Implement controls to ensure loan proceeds fully discharge all debts and prior liens as required.

- Employ pre- and post-closing reviews to detect any inconsistencies within the transaction.
- Conduct periodic independent audits of mortgage loan operations.
- Use IRS Form 4506 on all loans to facilitate full investigation of future fraud allegations.

FRAUD COMMITTED BY MORTGAGE ORIGINATORS

For the sake of providing a relatively uncontroversial definition of a mortgage originator for this outline, I would define one as a person who, for a fee, originates and places loans with a financial institution or an investor but does not service the loan. A mortgage originator may use its own funds, or funds borrowed from a warehouse lender, to fund mortgages. After a mortgage is originated, a mortgage originator might retain the mortgage in portfolio or might sell it to an investor. That's a very broad-based definition and should suffice to discuss how fraud is committed by mortgage originators.[14]

Consider the Red Flags we have identified over many years of audits, including schemes known to compliance personnel, regulators, and risk management firms such as Lenders Compliance Group®. Indeed, the list just grazes the huge number of fraudulent treacheries belabored by mortgage originators.

- No attempt is made to determine the financial condition of the mortgage originators or obtain references and background information.
- A close relationship exists between the mortgage originators, appraiser, and lender, raising independence questions.
- The broker acts as an advocate for the borrower instead of serving as the financial institution's representative/agent.
- High "yield spread premiums" are paid by the financial institution.
- Original documents are not provided to the funding financial institution within a reasonable time.
- An unusually high volume of loans with maximum loan-to-value limits have been originated by one mortgage originator.
- An uncommonly large number of foreclosures, delinquencies, early payment defaults, prepayments, missing documents, high-risk fraud characteristics, quality control findings, or compliance problems exist on loans purchased from any mortgage originator.
- A large volume of loans from one mortgage originator arrives using the same appraiser.
- High repurchase volume exists for a specific mortgage originator.
- Numerous applications from a particular mortgage originator are provided possessing unique similarities.
- A high volume of loans exists in the name of trustees, holding companies, or offshore companies.
- An unusually large increase is noted in overall volume of loans during a short time period.

CONTROLLING OUT-OF-CONTROL MORTGAGE ORIGINATORS

- Conduct an initial acceptance review and obtaining documentation to support mortgage originator approval.
- Review the mortgage originator's financial information as stringently as for other real estate borrowers.

- Ensure the financial institution's mortgage originator agreements requiring mortgage originators to act as the financial institution's representative/agent.
- Independently verify the mortgage originator's background information by checking business history outside of given references.
- Obtain a new credit report for the mortgage originator and checking for recent debt at other financial institutions.
- Obtain resumes of principal officers, primary loan processors, and key employees.
- Conduct state license verification.
- Conduct criminal background checks and adverse data base searches.
- Conduct an annual real estate-certification of mortgage originators.
- Conduct pre-funding reviews on all new production utilizing a pre-funding checklist.
- Conduct quality control (QC) underwriting reviews.
- Base mortgage originator compensation incentives on credit quality, documentation completeness, prepayments, fraud, and compliance.
- Establish measurable criteria that trigger recourse to the mortgage originator, such as misrepresentation, fraud, early payment defaults, failure to promptly deliver documents, and prepayments (loan churning).
- Hold mortgage originators and third-party contract underwriters responsible for gross negligence, willful misconduct, and errors/omissions that materially restrict salability or reduce loan value.
- Establish a mortgage originator scorecard to monitor volume, prepayments, credit quality, fallout, FICO scores, LTVs, DTIs, delinquencies, early payment defaults, foreclosures, fraud, documentation deficiencies, repurchases, uninsured government loans, timely loan package delivery, concentrations, and QC findings.
- Perform detailed vintage analysis, and tracking delinquencies and prepayments by number and dollar volume.
- Closely monitor the total number of loans and products from a single mortgage originator.
- Establish an employee training program that provides instruction on understanding common mortgage fraud schemes and the roles of a mortgage originator and on recognizing Red Flags.
- Establish a periodic audit of the originated mortgage loan operations, with specific focus on the approval process.
- Perform social security number validation procedures to validate borrower identity.

CHECKING FOR TITLE INSURANCE FRAUD

Title insurance refers to an insurance policy that protects the holder, lender, and/or owner from loss sustained by defects in the title. One way to understand this conduit to fraud is to realize it is a perfect access point for such chicanery. When a property is purchased, a lender and/or owner would require a title search and a title report (i.e., opinion), a document stating the status of the title, noting the existence of liens, easements, covenants, or

other claims and defects. Considering the range of possibilities for wrongdoing, what could go wrong?

Title insurance fraud has numerous Red Flags, of which the following are often committed by fraudsters who are “caught in the act.”

- The seller either is not on the title or is not the same as shown on the appraisal or sales contract.
- The seller owned the property for a short time with cash out on the sale.
- The buyer has a pre-existing financial interest in the property.
- The chain of title includes the buyer, realtor, or mortgage originator.
- The title insurance or opinion was prepared for and/or mailed to a party other than the lender.
- Income tax or similar liens are noted against the borrower on refinances.
- Delinquent property taxes exist.
- A notice of default is recorded.
- A modification agreement is apparent on an existing loan(s).
- A judgment exists against the borrower and is not shown on the credit report.
- Lien holders are not shown on the settlement statement.
- The title policy is not issued on the property with the lien or on the whole property.
- Faxes of documents are used rather than originals or certified copies.

THREE BASIC RULES FOR CONTROLLING TITLE INSURANCE FRAUD

1. Establish an employee training program that provides instruction on understanding common mortgage fraud schemes, evaluating title insurance/opinions, and recognizing Red Flags.
2. Include a review of the title commitment in the pre-funding quality assurance program.
3. Review the final title policy and checking for discrepancies with the original title commitment.
 - Compare the final title policy with other closing documents, like the settlement; statement, to ensure consistency regarding the first lien holder, lien amount, property size and location, and other pertinent information;
 - Employ a post-closing review to detect any inconsistencies within the transaction; and
 - Establish a periodic independent audit of mortgage loan operations.

VERIFICATIONS FRAUD: VOE

Many companies tend to see verifications as the primary way to get scammed by fraudsters. Obviously, given what I have outlined thus far, that is not the case. Nevertheless, verifications are pesky gateways to fraud that many underwriters encounter. The verification of employment is an independent corroboration of an individual's employment and income to substantiate what an applicant has reported on his mortgage application. Because the borrower's income eligibility is central to loan approval, mortgage fraud locks onto it like a heat seeking missile.

Examples of VOE fraud abounds, but these Red Flags can be in-your-face beguiling.

- Similarities in names, like the seller and applicant, are noted.
- The verification source is inappropriate (i.e., secretary or relative).
- The VOE is not on original letterhead or a standard FNMA/FHLMC form.
- The VOE is completed the same day it is ordered, indicating it may have been hand-carried or completed before the initial application date.
- An illegible signature exists with no further identification provided.
- The employer uses only a mail drop or post office box address.
- The employer is out of town, which may signal a nonexistent firm.
- The business entity is not in good standing with the state or registered with applicable regulatory agencies.
- An overlap exists with current and prior employment.
- The borrower changed professions in moving to current employer.
- Excessive praise is noted in the remarks section of response.
- Round dollar amounts are used in year-to-date or past earnings.
- Income is not commensurate with stated employment, years of experience, or type of employment.
- Income is primarily commission-based, which can indicate self-employment.
- The borrower is a business professional, which can be another indication of self-employment.
- The borrower's interest in the property is not logical given its distance from the place of employment.
- The borrower has a recent large increase in income or started a new job for which he does not appear qualified.
- Forms received contain last minute changes.
- Faxes of documents are used in lieu of originals.

CONTROLLING FOR VOE FRAUD

- Establish an employee training program that provides instruction on common mortgage fraud schemes, performing proper VOE, and recognizing Red Flags.
- Detail specific employment verification procedures in the pre-funding quality assurance program.
- Independently verify employment by researching the location and phone number of the business.
- Ensure the address information on W-2 forms and tax returns match data provided on the application.
- Determine if the employer is within a logical distance from subject property.
- Employ a post-closing review to detect any inconsistencies within the transaction.
- Establish a periodic independent audit of mortgage loan operations.

VERIFICATIONS FRAUD: VOD

Deposit verification is part of the class of asset verifications. The VOD permits an independent assessment of the status of an individual's depository accounts to corroborate what an applicant has reported on the mortgage loan application.

For schemers, VODs provide a rich mine of fraud tactics, such as the following ruses.

- The VOD is completed on the same day it was ordered.
- Deletions or cross-outs exist on the VOD.
- No date stamp was affixed to the VOD by the depository to indicate the date it was received.
- The buyer has no deposit accounts, but a VOD is in the file.
- The deposit account is not in the borrower's name or is a joint account with a third party.
- The borrower's account balance at the financial institution is insufficient to close the transaction.
- The deposit account is new or has a round dollar balance.
- The closing check is drawn on a different financial institution.
- An existing loan is secured by the checking or savings account.
- An illegible signature exists with no further identification provided.
- Significant balance changes are noted in depository accounts during the two months prior to the date of verification.
- The checking account balance is excessive versus the savings account balance.
- The checking account's average two-month balance exactly equals the present balance.
- Funds for the down payment are only on deposit for a short period.
- Young borrowers have a substantial amount of cash in the financial institution.
- A low-income borrower has a large amount of cash in the financial institution.
- An IRA is shown as a source of down payment funds.
- The down payment source is held in a non-depository "depository," such as an escrow trust account, title company, etc.
- An escrow receipt is used as verification, which may have been from a personal check that has not yet cleared, or a check returned due to insufficient funds.
- The VOD is not folded, indicating it may have been hand carried.
- The VOD is not on original financial institution letterhead or a recognized form.

CONTROLLING FOR VOD FRAUD

- Establish an employee training program that provides instructions on common mortgage fraud schemes, performing proper VOD, and recognizing Red Flags.
- Detail specific deposit verification procedures in the pre-funding quality assurance program.
- Independently verify the legitimacy of the depository by researching its location and phone number.
- Validate borrower provided information on the application by making direct inquiries to the depository regarding the account's name, age, average balance, number of monthly transactions, recent large dollar transactions, etc.
- Employ a post-closing review to detect any inconsistencies within the transaction.
- Establish a periodic independent audit of mortgage loan operations.

FRAUD DETECTION - QUESTIONNAIRES

In risk management, questions are sometimes more important than answers. Or, to put a fine point on it, the framing of questions relating to mortgage fraud is sometimes more important than the range of possible answers. If the right questions are asked, the company is in a better position to determine its fraud detection strategies. Having a set of basics, like the outline I have provided, is one of many steps to identify and control for mortgage fraud. However, these are not questionnaires!

A savvy lender must develop fraud detection questionnaires for at least the following areas: loan applications, appraisals, credit reports, sales contracts, title policies, chain of title, income and employment verification, asset verification, closing procedures and settlement statements. Over many years, Lenders Compliance Group® has developed extensive fraud detection questionnaires that assist us in conducting our audits and drafting appropriate policies and procedures. In developing a program to monitor and mitigate mortgage fraud, it is in the company's best interests to periodically build and continually update its own fraud detection questionnaires.

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- [1] 18 USC 1001
 - [2] 18 USC 1010
 - [3] 18 USC 1014
 - [4] 18 USC 1028
 - [5] 18 USC 1341
 - [6] 18 USC 1342
 - [7] 18 USC 1343
 - [8] 18 USC 1344
 - [9] 42 USC 408(a)
 - [10] Georgia Residential Mortgage Fraud Act, SB 100
 - [11] *Appendix F: Money Laundering and Terrorist Financing "Red Flags"*, Bank Secrecy Act, Anti-Money Laundering Examination Manual
 - [12] Along with other government agencies, such as the National Credit Union Administration (NCUA)
 - [13] *Supplement A to Appendix A*, Appendix A to Part 681, "Interagency Guidelines on Identity Theft Detection, Prevention, and Mitigation," 72 FR 63771, Nov. 9, 2007, as amended at 74 FR 22646, May 14, 2009
 - [14] Mortgage servicers are excluded for the purposes of defining a mortgage originator.



Labels: [Anti-Money Laundering](#), [Credit Risk](#), [Identity Theft](#), [mortgage fraud](#), [Mortgage Fraud Litigation](#), [Mortgage Fraud Red Flags](#), [Mortgage Risk Management](#)

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