

# Compliance Clinic

## Mortgage fraud wave requires strict regimen to resist

Industry experts estimate that 10%-15% of the \$2.8 trillion in home mortgage loans generated in 2005 contain some form of fraud or misrepresentation. That means that several hundred billion dollars in mortgage debt incurred last year involved some element of dishonesty.

Increasing mortgage loan fraud imposes significant costs on lenders.

One cost is readily identifiable—fraudulent loans that must be bought back out of mortgage packages, because investors typically require this when loans reveal indications of fraud. Consequently, a mortgage lender is either forced to service the loan itself (which may be under-collateralized) or sell it at a significant loss.

Even more significant are the elevated risks of reputation damage, litigation, and enforcement. Despite an increased focus on fraud by enforcement agencies, new and more sophisticated schemes evolve constantly. At best, law enforcement is mostly reacting, and just barely keeping up. Consequently, as a practical matter, lenders must look to their own efforts by implementing an aggressive fraud prevention and detection program.

More than lenders are harmed. Mortgage fraud imposes costs on a broader scale: on homeowners, who must indirectly pay for the increased costs that fraud imposes; on neighborhoods, afflicted by fraud; and on taxpayers, who must shoulder the cost of combating it.

Mortgage fraud has been defined as “material misrepresentation”—the giving of false information that deceives or misleads a lender into extending credit beyond the limits of what would normally be extended if the facts were known.

The first part of this article identifies the most common mortgage frauds and provides statistics.

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### Red flags that warn that mortgage fraud may be going on in your bank

- ✓ Unsigned or undated application
- ✓ Non-matching signatures on application documents
- ✓ Multiple applications from same borrower
- ✓ Same telephone number for borrower's residence and business
- ✓ Significant increase in borrower housing expense
- ✓ Borrower income inconsistent with type of employment
- ✓ Items on credit report do not match those listed on application
- ✓ Use of power of attorney with no explanation
- ✓ Discrepancies between HUD-1 and escrow instructions
- ✓ Years of education inconsistent with borrower's occupation
- ✓ Significant amount of cash out in a refinance
- ✓ Brokers with high concentration of purchase money loans
- ✓ Recent significant increase in appraised value

### CD's available from ABA mortgage fraud seminar

ABA presented a telephone briefing, “Mortgage Fraud: Does Your Bank Take Effective Precautions?” on May 3. Audio CDs are available for those who missed the live event at a rate of \$255 for ABA members and \$385 for nonmembers. For more information, call 800-775-7654 and ask about program 11681.

The second part cites recent examples of government investigations; settlements and agreements; and enforcement actions. It also summarizes recently issued government guidance.

The third part offers options for lenders in fraud prevention and detection.

### *Three Faces Of Fraud*

Mortgage fraud takes many forms, but three are commonly recognized:

*Fraud for profit* is a form of industry insider fraud. It involves such schemes as falsely inflating the value of properties and repeatedly “flipping” them. This

entails issuing loans based on fictitious properties, misrepresenting investment property as owner-occupied property, misrepresenting personal identity, or using false or forged documents (often through “straw buyers”) to obtain a loan, and creating fictitious or nonexistent payees of monetary instruments.

Such mortgage fraud is the most costly to lenders because the schemes often involve multiple transactions. In fact, the FBI says that 80% of all reported losses from fraud involve collaboration or collusion by industry insiders.

*Fraud for housing* involves an individual borrower defrauding a lender to purchase a house for the borrower’s own use. Examples include the misstating of income or expenses; disguising the source of the down payment; and providing false or forged documentation.

In many instances, a fraudulent borrower receives assistance from a complicit third party, such as a broker, appraiser, developer, builder, or financial adviser. Consequently, fraud for housing also may constitute fraud for profit—albeit on a smaller scale—because complicit third parties receive compensation for their role in the fraud.

*Fraud for other criminal purposes* involves the perpetrator’s use of illegally obtained funds in real estate transactions. For example, a drug trafficker may purchase real estate at an inflated price for the purpose of money laundering; a terrorist may purchase a safe house; or another criminal may purchase real estate to facilitate such crimes as drug manufacturing, smuggling, prostitution, counterfeiting, or running a “chop shop.”

#### **How much is out there?**

The true level of mortgage fraud is largely unknown. No federal agency is tasked with maintaining national mortgage fraud data and many cases go undetected or unreported.

But the limited data that is available paints a picture of rapidly increasing fraud. For example, the Financial Crimes Enforcement Network reported in the February 2006 *SAR Activity Review* that, since April 1996, 61,278 Suspicious Activity Reports have been filed that identified mortgage fraud as the suspicious activity. Forty-eight percent of these reports were filed in 2004 and 2005.

FBI statistics indicate that the number of complaints of fraud has doubled since 2001. There were 721 pending FBI mortgage fraud cases in fiscal 2005, up from 534 in fiscal 2004. Similar figures are reported by the Internal Revenue Service, which also hunts mortgage fraud through its tax and money laundering investigations. The number of mortgage fraud cases initiated by IRS Criminal Investigation doubled between fiscal years 2001 and 2003. In addition, CI's statistics for fiscal 2004 reflect a three-year high for the number of cases recommended for prosecution as well as cases resulting in an indictment, sentence, and incarceration.

Finally, although mortgage fraud is recognized as a nationwide problem, certain regions have seen markedly higher incidences. The FBI finds that recent surveys indicate that 26 states have significant mortgage fraud problems. The states identified by survey respondents were concentrated in the South and West, with Georgia and Florida leading. In addition, Mississippi has been emerging as a state with a high incidence of fraudulent activity.

### *Investigations And Regulatory Actions*

Enforcement agencies have stepped up efforts and collaborated closely with lenders and national associations to address mortgage fraud, particularly fraud by insiders. Some investigations have taken several years, including a notable eight-year investigation in Los Angeles that culminated in more than 20 convictions of individuals who manufactured and submitted false documents to lenders.

Other investigations have progressed more swiftly. One example is Operation Quick Flip, in which the Department of Justice indicted 156 mortgage fraud subjects during the period of July 5, 2005 to Oct. 27, 2005. As a result of this operation, 89 convictions were obtained—but not before the subjects had caused a combined loss to lenders of more than \$606 million.

In another action, last August the U.S. Attorney for the Southern District of Mississippi announced a 47-count indictment against three individuals and a related 20-count indictment against a fourth individual for their involvement in a mortgage fraud scheme. The three individuals charged had allegedly conspired

to prepare fictitious documents (e.g., verification of deposit documents, verification of rent documents, and documents verifying a borrower's income) and to create fictitious creditors to whom borrowers allegedly were indebted. The fourth individual, a mortgage broker, was accused of conspiring to match up prospective borrowers with mortgage lenders by performing loan origination services for borrowers and submitting loan applications to lenders for a fee.

In another recent matter, in September 2005 the U.S. Attorney for the Northern District of California announced that a federal grand jury had issued a 46-count indictment against two individuals and an unlicensed, unincorporated entity called the Dorean Group for alleged involvement in a nationwide debt elimination scheme that had caused home mortgage and equity loans to falsely appear satisfied when they had not been paid.

filed against Market Street Mortgage Corporation by a former employee. The employee had claimed that Market Street had submitted false and fraudulent documents relating to loan applicants' employment, "gift" letters, credit references, and Social Security documents to qualify certain applicants for government loans.

In August 2004, the United States Attorney announced a settlement agreement with Market Street. In the settlement, Market Street agreed to reimburse the government \$700,000 and indemnify the government from potential losses relating to 83 specific mortgages, which contain a face value exceeding \$5 million.

### **Option One Mortgage Corp.**

In 2005, the U.S. Attorney for the Eastern District of Pennsylvania announced a Joint Agreement with Option One Mortgage Corporation regarding the company's anti-fraud pro-

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In addition to criminal investigations involving fraud artists, government agencies are increasingly taking a hard look at lenders themselves. The lenders in many cases are the victims of fraud, but they may lack effective policies and procedures to prevent mortgage loan fraud. Three recent resolutions of government inquiries and/or litigation are discussed below. While each of these matters involved distinct issues, these resolutions provide significant guidance to lenders with respect to expectations for industry best practices.

### **Market Street Mortgage Corp.**

In the Eastern District of Pennsylvania, the U.S. Attorney intervened in an action

gram. The U.S. Attorney's Office had learned through an investigation that independent mortgage brokers had submitted fraudulent loans to Option One in the form of inflated appraisals, fictitious charitable grants applied toward down payments, misrepresentations of cash brought to closing, and excessive brokers' fees, which were used to recoup funds that brokers provided to borrowers for down payments.

In response to the government's inquiry—in which the authors of this article represented Option One—the company began a comprehensive review of its internal controls. This review led to the enhancement of many fraud-related policies and procedures, including: the

reorganization of its corporate structure; the creation of new anti-fraud policies (such as a source and seasoning requirement for down payment funds); the development of targeted broker reviews; the creation of an anonymous fraud hotline; the creation of two fraud prevention

committees, and the enhancement of its broker approval procedures.

The Joint Agreement praised Option One's proactive approach and noted that the company had been forthcoming, responsive, cooperative and receptive to suggestions during the federal inquiry.

#### **Argent Mortgage Co.**

Also in 2005, Argent Mortgage Company consented to a cease and desist order issued by the Georgia Department of Banking and Finance. The order, dated Sept. 6, 2005, directed Argent to: adopt policies and procedures that comply with state laws and regulations; enhance its broker approval and review process; and report suspected mortgage fraud activity by a broker to the department.

Argent also agreed to implement a set of best practices that derived largely from a key white paper issued by the Federal Financial Institutions Examination Council (*The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper*, issued February 2005).

In particular, the Consent Order required Argent to adhere to guidelines with respect to broker monitoring, employee training, pre-funding reviews, underwriting policies and anti-flipping policies. Argent was also required to establish methods for determining properties' occupancy status and to provide special instructions to closing agents. And finally, Argent was required to strengthen (or outsource) its appraisal review process.

#### ***Protecting Your Bank***

The resolutions cited above, as well as the FFIEC white paper, provide a reasonable starting point for a lender seeking to develop an effective anti-fraud program. We believe that some or all of the following should be among the chief components of any such program:

#### **Corporate commitment**

- Ensure the presence of corporate and senior management commitment. Combat the perception that lenders—particularly nonprime lenders—are more focused on volume generation than fraud detection.
- Demonstrate to employees that good business sense can and should include a focus on addressing the increasing incidence of fraud.

#### **Corporate structure**

- Separate the ultimate responsibility for fraud detection and prevention from the lines of business responsible for originations.

- Place responsibility for fraud detection and prevention in the hands of the Chief Risk Officer or individual with similar position.
- Create a Senior Fraud Steering Committee with policy-making responsibilities and a lower-level Operational Fraud Committee, responsible for day-to-day oversight of the implementation of such policies. For smaller lenders, it may be appropriate for the audit committee of the board of directors, in consulta-

tion with management, to operate in lieu of a Senior Fraud Steering Committee.

#### **Broker approval and monitoring**

- Separate the broker approval process from lending operations.
- Conduct meaningful due diligence, including background checks. Require a Social Security Number for all principals. Utilize cross-enterprise exclusionary lists (e.g., Fannie Mae, Freddie Mac, affiliated companies, industry groups).
- Score brokers based on objective crite-

ria that are related to fraud, such as volume, prepayment rate, credit quality, loan-to-value and debt-to-income ratios, fallout rate, delinquencies, defaults, foreclosures, repurchases, timely loan package deliveries, quality control findings.

- Place brokers on a watch list during a probationary period (say the broker's first five loans). Place brokers on a watch list where there is suspicion, but not confirmation, of fraud. Review applications from brokers on the list on a pre-funding

### **Crossing the Line on Bounce Protection**

**Q** *Let's say my bank does not advertise nor promote its bounce protection policy, but does provide the consumer with a balance at the teller window or on an ATM receipt that includes both the actual balance plus the potential overdraft amount. Must the bank comply with the requirements to separately aggregate the overdraft fees and non-sufficient fund fees?*

**A** Yes. "Promoting," for the purpose of the regulators' periodic statement aggregation requirements, includes disclosing an overdraft limit. Specifically, Comment 2(iii) to Section 230.119(a)(1) provides that a financial institution triggers the periodic disclosures requirement if it "discloses an overdraft limit or includes the dollar amount of an overdraft limit in a balance disclosed by any means, including on an ATM receipt or on an automated system, such as a telephone response machine, ATM screen, or the institution's Internet site."

### **Giving Credit Where It Is—Or Isn't—Due**

**Q** *We recently changed how our credit line product is booked—posting them with a five-year maturity. The loan documentation contains a provision that there will be an annual review of the credit to decide if the line of credit can continue. The loan officer must re-approve the credit for it to be allowed to continue. Can these "five-year" lines be reported for CRA as a renewal each year?*

**A** The CRA Questions and Answers at §11.42(a)–5 state that a "renewal" extends the term of the loan. So the answer appears to rest with what you mean by "post a five-year maturity" on your loans. If the loan has a five-year maturity as part of the contract, you do not appear to have extended the term in years 1, 2, 3, or 4. However, if you are just internally posting a five-year maturity but the loan states it is due and payable in one year unless extended upon further credit review, and you actually do the credit review annually, then it likely would be treated as a renewal when you completed your review and decided to extend the loan. However, if you are just doing

a review for conditions of default or financial deterioration that might trigger accelerated demand, and otherwise the customer has the loan for five years under its original contract, examiners would probably question treatment of the annual review as a "renewal."

### **RESPA's Record Retention Reach**

**Q** *What are the record retention requirements under the Real Estate Settlement Procedures Act when a bank sells a covered mortgage loan and transfers the servicing on the loan?*

**A** Regulation X, administered by the Department of Housing and Urban Development, does not address this issue in a uniform manner. In Section 3500.10 (e) the recordkeeping requirement specifically allows a lender to remove itself from the general five-year retention requirement for the HUD-1 or HUD-1A and "related documents," if the lender sells the loan and transfers the servicing. In that case the retention responsibility shifts for whatever term remains of the five years to the new party. However, if you are transferring a loan with an escrow account, there is a requirement that you retain those account records for "at least" five years after you last serviced the account. (See, Section 3500.17(l) (2)) Another caveat: disclosures provided in connection with an affiliated business arrangement have their own retention requirement of five years under Section 3500.15(d)—and there is no express exception to this rule for loan sale or servicing transfer. (See also, Section 3500.14(e))



ABA experts have been answering selected banker questions in this space, while Bill Hood, who mans ABA's help desk for the association's Compliance Center, is on hiatus. To submit questions, write to the Compliance Center at ABA, 1120 Connecticut Ave., N.W., Washington, D.C. 20036; call at (202) 663-5491; or send an e-mail to

[compliance@aba.com](mailto:compliance@aba.com). E-mailers please include bank name, phone number, and address.

basis, using a detailed checklist.

- Maintain a list of barred individuals and business entities to ensure that loan officers cannot do business with the lender by joining or forming another broker company.
- Be mindful that brokers connected with fraud frequently contribute to fair lending and compliance risk as well. This arises through unexplained pricing disparities or manipulation of decisioning engines.

### Pre-funding reviews

- Review a robust sample of loans prior to funding. The sample should be based on objective factors, such as geography, loan characteristics, underwriting exceptions, or changes in key loan data prior to approval. Include in the pre-funding reviews both inbound and outbound calls to re-verify employment, assets, or rental history.
- Utilize a formal checklist for pre-funding anti-fraud reviews.

### Underwriting and processing

- Emphasize the importance of fraud detection and prevention as part of employees' day-to-day responsibilities.
- Ensure that training remains up to date on emerging fraud schemes. Provide guidance to underwriters and processors in identifying "red flags."

### Post-funding reviews

- Ensure that there are multiple triggers for post-funding reviews, such as delinquency reports (actual versus expected delinquencies); branch requests; input from appraisal, servicing, asset management and compliance departments; and information gathered from customer complaints or past reviews.

### Special targeted reviews

- Identify brokers and account executives for periodic, targeted reviews based on factors such as loan performance and product mix.
- Select branches and/or originators for targeted reviews based on loan-level and geographical risk factors.

### Appraisal issues

- In connection with each origination, independently confirm the appraiser holds a valid license or certificate.
- Test the appropriateness of appraisals obtained by brokers and correspondents

by obtaining independent automated valuation models and appraisals.

- Review appraisals, at least on a sample basis. If a lender chooses to review a sample, rather than conduct a 100% appraisal review, it should focus on high-risk areas.
- Maintain an appraiser watch list and suspended appraiser list.

### Closing department

- Monitor closing agents. Focus on high-risk geographies and delinquency reports (actual versus expected delinquencies).
- Maintain lists of on-watch and suspended closing agents.
- Provide anti-fraud training to branch closers.
- Require additional documentation for loans submitted by brokers who are affiliated with a closing agent.

### Closing agent responsibilities

- Require closing agents to adhere to an objective set of closing instructions, including, for example:
  - Obtaining and reviewing identification from all parties to the transaction.
  - Ensuring that all payments made from closing funds are appropriately documented.
  - Verifying that source of funds for closing come from the borrower and not a third party.
  - Accepting certified funds only from a financial institution that is a verified depository.
  - Notifying the lender of any known transaction involving the borrower or subject property within the previous 12 months.

### Policies and procedures to deter fraud

- Establish a fraud hotline for anonymous tips.
- Implement a policy on source and seasoning of funds for down payments, in order to detect and deter situations where an undisclosed third party provides the source of borrower down payments.
- Avoid potential property flipping by declining to originate a loan on a property that has had a recent prior sale and/or by requiring enhanced documentation.
- Validate all borrowers' Social Security numbers.
- Validate the occupancy status of collateral to distinguish between primary

residences and investment properties.

## Training

- Ensure that all employees complete anti-fraud training upon commencement

for all branch/center personnel involved in the loan origination process and those involved in other areas of fraud detection and prevention.

- Require employees to certify that they

## Working with third parties

- Provide a strong public message regarding the lender's anti-fraud policies. Where possible, your bank should offer anti-fraud training and resources to third parties, such as brokers, appraisers and closing agents.

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**“Provide a strong public message regarding your bank’s anti-fraud policies. Where possible, your bank should offer anti-fraud training and resources to the third parties that it works with, including brokers, appraisers, and closing agents”**

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## Reporting of fraud

- In the case of non-depository institutions, file a Suspicious Activity Report whenever there is a reasonable belief that an instance of fraud has occurred (filing of such reports is mandatory for depository institutions).
- Where there is suspicion of appraisal fraud, notify the relevant state’s appraiser board.
- Participate in third party fraud reporting services through which lenders share information regarding perpetrators of mortgage loan fraud. *BJ*

of employment and upon material revision of anti-fraud policies or procedures.

- Conduct specialized “red flags” training

have completed anti-fraud training and have them recertified for that qualification on an annual basis.