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COMMENTARY

Best Practices, Common Sense Help Detect Mortgage Fraud

By Anna DeSimone

MORTGAGE FRAUD IN THE UNITED STATES is pervasive and growing. Over the past three years, the number of SAR (suspicious activity report) filings related to mortgages has tripled and the number of investigations processed by the FBI has quadrupled. By definition, mortgage fraud schemes contain some type of material misstatement, misrepresentation or omission in the funding, purchase or insuring of a loan.

There are two distinct types of mortgage fraud. Fraud for housing represents borrowers who make false statements in order to qualify for a loan. Fraud for profit involves collusion by industry insiders and, according to the FBI, accounts for 80 percent of fraud cases. Mortgage originations dropped $1 trillion between 2003 and 2004. Sadly, it is the reduction in loan originations that is considered a factor in the escalation of fraud. If the perpetrators of mortgage fraud are industry insiders, they can maintain their lifestyle despite a decrease in business. Perpetrators of mortgage fraud often use false or stolen identities or financial accounts of real people. An example of business identity theft is the illegal use of another real estate appraiser's name or license number.

In June 2004, the FBI consolidated its mortgage fraud program into the Financial Crimes Section of the agency's Criminal Investigative Division and has been proactive in forming partnerships with federal agencies, regulators and industry trade groups to combat fraud. The FBI embarked on a zero-tolerance program within the mortgage industry to identify and stop the front line of industry insider wrongdoing through mandatory reporting. Insiders are defined as appraisers, accountants, attorneys, real estate brokers, mortgage underwriters and processors, settlement/title company employees, mortgage brokers and loan originators.

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The FBI has collaborated with the Mortgage Bankers Association of America and industry leaders to establish broader SAR requirements for mortgage lenders. Nondepository lenders, appraisers, brokers and other mortgage professionals who do not have adequate protection under the current safe harbor program would file a Suspicious Mortgage Activity Report, known as the SMARt Form.

Over the past 10 years, major mortgage lenders, agencies and insurers have been submitting information describing incidents of alleged fraud and material misrepresentation to a central database. The database is maintained by the Mortgage Asset Research Institute (MARI) and the database is known as the Mortgage Industry Data Exchange (MIDEX). MARI can mine the MIDEX database to obtain statistics on a wide range of mortgage fraud characteristics. The MIDEX data show relative stability over the past four years with respect to the types of mortgage fraud.

In MARI's Seventh Annual Fraud Case Report to the Mortgage Bankers Association in May 2005, the fraud reported on 2004 originations was classified as follows: loan application and borrower identity, 56 percent; tax returns, 33 percent; deposit verifications, 16 percent; employment verification, 12 percent; and collateral, 10 percent. The total exceeds 100 percent because most reported incidents involve more than one type of fraud.

Controls and Deterrence

The geographic distribution of mortgage fraud is predominantly in the South and Western regions of the country. MARI publishes a Fraud Index for each state that quantifies the rate of fraud in relation to the level of fraud that would be expected based on the volume of loan origination. For prime mortgage lenders, mortgage fraud for South Carolina and Georgia are three times greater than the expected rate. North Carolina and Missouri have twice the expected rate of fraud, followed by Florida, Texas, Utah, Illinois, Michigan and Indiana. For subprime lenders, the top 10 states in ranking order are: Georgia, Florida, South Carolina, Nevada, Utah, Michigan, New York, Arizona, Mississippi

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and North Carolina.

Lenders must deploy fraud detection and deterrence steps on both a pre-funding and post-funding basis. While many mortgage programs in today's industry call for less documentation and verification, lenders are cautioned to use stricter controls. Fannie Mae and Freddie Mac have strengthened quality control requirements on SISA (stated income, stated asset) loans. Quality-control steps must include a salary reasonableness test to assess whether the borrower's stated income conforms to the industry, geographic area and job title. This may be completed at no cost through the Web site www.salary.com. A second step for quality-control auditors is to validate the employer through telephone and Web directories. Verbal re-verifications of employment are also completed and documented by quality-control staff.

Most lenders and secondary-market investors require a 4506 or a 4506-T tax form to be signed by borrowers at closing. This authorizes the lender to obtain copies of tax transcripts from the Internal Revenue Service, but only if the quality-control re-verification is completed within 60 days of closing. While the industry generally orders tax return transcripts for self-employed borrowers, the 4506-T form also enables lenders to obtain a W-2 wages-only verification. Fast, easy and inexpensive, this one-line transcript immediately identifies bogus W-2 forms. Fabricated W-2 forms are very common because these standard forms can be purchased in any stationary store. Paystubs have been created through sophisticated use of computer word-processing graphics.

In light of today's awareness of consumer privacy and information security, lenders must take careful measure to ensure that all document re-verification on a pre-funding and post-funding basis is treated confidentially. Before faxing an employment-verification form, the receiver should be notified. Mailed re-verifications should be addressed to the signer of the original employment verification or addressed to payroll and clearly marked confidential on the outside of the envelope.

Re-verification of checking or savings account statements often is neglected since they appear authentic. However, financial statements may be cut and pasted to show higher account balances belonging to another person and the pasting is virtually undetectable after photocopying.

There are a wide number of tools and resources available for lenders in the area of fraud detection. Lenders must train staff on mortgage fraud trends and issue clear directives on an inter-departmental level. Often, the best method for fraud detection is to use plain old-fashioned common sense. An investor's document requirements are only a guideline – asking for more proof means less risk. ■