

Gotcha!

Mortgage Industry Turns Up Heat on Fraud Artists

by Michele M. Walczak

Two Federal Bureau of Investigation (FBI) sting operations in Southern California lead to indictments against 27 housing-industry practitioners for filing falsified mortgage applications.

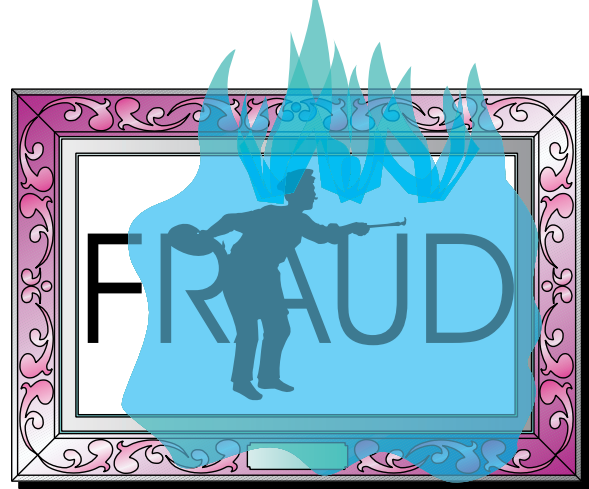
A Washington, DC, mortgage broker is serving a four-year-plus prison sentence after pocketing \$3 million from fraudulent originations.

Federal investigators shut down a New Jersey-based conspiracy among eight housing professionals who over-inflated property values and reaped \$6 million in excess mortgage-financing proceeds.

AS THE HOUSING-FINANCE industry steps up efforts to curb mortgage fraud, score three more victories for the good guys.

Greater collaboration among industry players, more assistance from federal and state investigators and stricter criminal penalties have put the housing-finance community today in a much better position than ever to combat mortgage fraud. The industry now is working proactively and cooperatively to

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prevent fraud, a marked departure from years of simply trying to recoup losses.

Looking Under the Rug

Mortgage fraud is nothing new; nor are the types of fraud perpetrated today all that different from those in past decades. Phony loan documents, inaccurate tax returns and falsified verifications of employment and deposit still are the fraud artist's tools of the trade. But as scams have become increasingly elaborate and dollar losses suffered by some financial institutions have run into the millions, industry players and law-enforcement agencies have banded together to protect lenders' business. The objective is to preserve the efficient, effective operation of both the primary and secondary mortgage markets.

Quantifying the pervasiveness of fraud throughout the lending community is difficult. Few lenders, if any, keep formal records of fraud-related damage; typically, lenders do not separate fraud losses from overall credit losses.

Data collected by the FBI do shed some light on the prevalence of mortgage scams, though only for certain financial institutions. Only federally insured banks, thrifts and credit unions are required to report known or suspected criminal activity to the appropriate law-enforcement agencies and to their financial regulators.

Of the more than 44,000 fraud incidents reported by federal financial institutions in 1996, a relatively low 3.2 percent involved mortgage-loan deceptions. However, these cases accounted for a relatively high

12.9 percent of total financial losses among the companies (*Exhibit 1*).

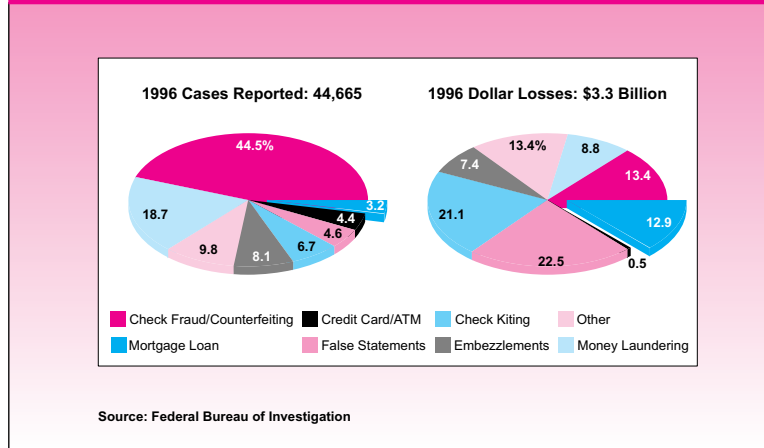
Tracking the Bad Guys

Industry efforts to tackle mortgage fraud head on now involve lenders, mortgage insurers and secondary-market companies which include Freddie Mac and Fannie Mae. Many of these firms are making greater use of background checks to save them from doing business with individuals with questionable or criminal records. A growing number of lenders also are introducing internal quality-control measures earlier in the loan-funding process, that is, before a mortgage is originated. Others are subcontracting with third parties to confirm the veracity of loan-application information and supporting documentation.

The methods by which mortgage fraud is perpetrated vary. A borrower might intentionally misreport personal income to secure a home loan. An appraiser might report an inflated property value. Or, to close a loan, a mortgage broker might supply false information about a borrower's employment history or owner-occupancy status.

However, these scenarios—and well over half of the fraud occurrences tracked by the Mortgage Asset Research Institute in Reston, VA—share a common denominator: a loan-application package containing false application information (*Exhibit 2*).

EXHIBIT 1: Financial-Institution Fraud by Type



A relatively small number of mortgage-fraud incidents reported by federal financial institutions in 1996 contributed disproportionately to total dollars lost due to all types of banking fraud.

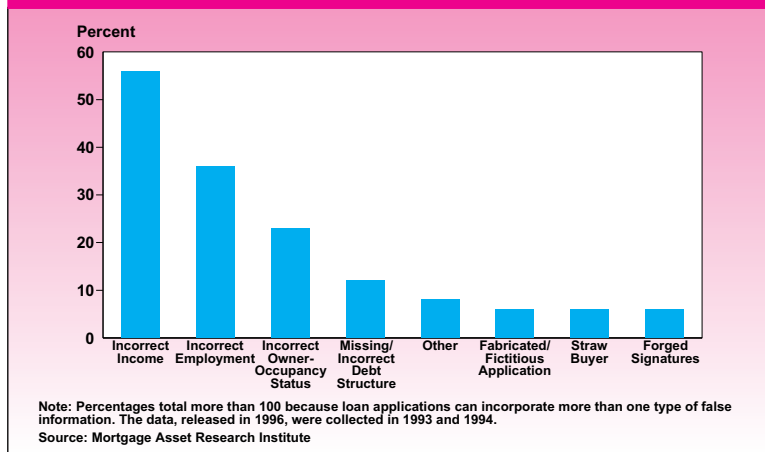
EXHIBIT 2: Mortgage-Fraud Types

Application Information	59%
Tax Return	57
Employment Verification	47
Bank Deposit Verification	30
Appraisal/Value	7

Note: Percentages total more than 100 because loan-application packages can incorporate more than one type of false information. The data, released in 1996, were collected in 1993 and 1994.
Source: Mortgage Asset Research Institute

One or more of the documents required to complete a mortgage-application package can contain false information. Fraudulent application information tops the list. Incorrect tax return information ranks a close second.

EXHIBIT 3: Fraudulent Information Appearing on Mortgage Applications



On more than one-half of fraudulent mortgage applications observed, the borrower's income is incorrect. Other inaccuracies, such as the length of employment or amount of indebtedness, also may appear on the same loan application.

Complicating the duplicity, many loan applications include more than one type of deceit (*Exhibit 3*).

To discover tainted loan applications more quickly and consistently, companies that normally compete with one another are contributing cases to fraud-tracking databases. Such information can be accessed and cross-checked against mortgage applications before loans are funded.

The Mortgage Asset Research Institute made one such database commercially available in 1995. The Mortgage Industry Data Exchange (MIDEX) serves as a computerized clearinghouse for mortgage-industry fraud. The proprietary database includes reports of alleged fraud, material misrepresentations and other

suspicious incidents. It also incorporates public information on criminal, civil, enforcement and administrative actions against individuals and companies within the real-estate and financial-services fields.

The National Fraud Investigation Center, based in Horsham, PA, also tracks swindlers, but it does so across a spectrum of industries. The center operates on the premise that fraud is not always industry specific; those who commit cellular-phone fraud, for example, easily can cross over into credit-card or mortgage fraud.

Technology now in development also should give the industry another advantage in its battle with fraud artists. Electronic loan-verification systems, for instance, can foil

lawbreakers who have managed to replicate paper-based loan documentation with picture-perfect accuracy.

A pilot program in California that teams lenders with the Internal Revenue Service (IRS) is making it difficult for unscrupulous mortgage brokers or borrowers to submit fraudulent income information on their loan applications. Participating lenders can fax income-verification requests directly to the IRS and receive an answer the same day.

Widespread adoption of automated underwriting technology will allow lenders direct access to credit repositories and property-value databases, eliminating opportunities for dishonest intermediaries to invade the loan process.

The Feds Lend a Hand

Through an initiative launched more than one year ago, the FBI likewise has stepped up its anti-fraud efforts. Rather than waiting to act until a financial institution is victimized, FBI agents are going undercover to stop individuals before they defraud the system.

In 1996, the FBI unraveled one of the most elaborate mortgage-fraud schemes to date when it apprehended a ring of New Jersey housing professionals dealing in over-inflated mortgages. The lawbreakers began by recruiting straw buyers—people willing to lend

their names, social security numbers and credit records to someone else's loan application. The conspirators then applied for excessively high mortgage amounts based on overblown property appraisals. Many of the properties, typically residential rentals managed by scam insiders, went into foreclosure six months to 12 months later. The schemers pulled the stunt more than 100 times, bilking four banks out of \$6 million in the process. The house of cards began to collapse after one bank, suspicious of identical names on applications associated with some of its problem loans, notified the authorities. Subsequent FBI action led to the arrest of eight individuals.

In another sophisticated scheme, a Washington, DC, mortgage broker set up a bogus lending operation and siphoned off an estimated \$3 million in fraudulent loan proceeds. He supplied more than 10 lenders with phony business references and set up answering services in Dallas, Atlanta, Chicago, Seattle and Washington to verify loan-application information. He also fabricated borrower tax returns, credit reports, verifications of employment and verifications of deposit. As a result, the broker was able to sell properties for which he had paid only \$30,000 to straw buyers for as much as \$240,000. The broker then originated the mortgages to finance the purchases and

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unloaded the bad loans on unsuspecting lenders.

The fraud artist's setup unraveled when a Michigan lender, contacted because of an early loan default on an alleged \$200,000 home, had the property reappraised and discovered its true value. The scam originator was arrested in 1996 following an FBI investigation. In early 1997, he was sentenced to serve 51 months in prison.

The mortgage broker's jail term, relatively severe by traditional white-collar-crime standards, is evidence of recent efforts by the courts to get tough with fraud perpetrators. In 1990, the Federal Sentencing Guidelines changed according to a Congressional mandate to require a longer 51-month minimum prison term for fraud convictions resulting from cases in which the

perpetrator stole more than \$1 million or jeopardized the safety and soundness of a federally insured financial institution. This lawbreaker, though, did manage to avoid the stiffest penalties allowed under the new sentencing guidelines, a 30-year prison term and a \$1 million fine.

Some state judiciaries also are throwing the book at mortgage-fraud offenders. In May, a real-estate broker operating in the Santa Clara County area of California received the maximum 10-year sentence allowed under state law after he was convicted on 28 counts of grand theft. Over the course of three years, the broker diverted \$400,000 entrusted to him by 300 borrowers to make their mortgage payments under an accelerated loan-repayment program devised by him.

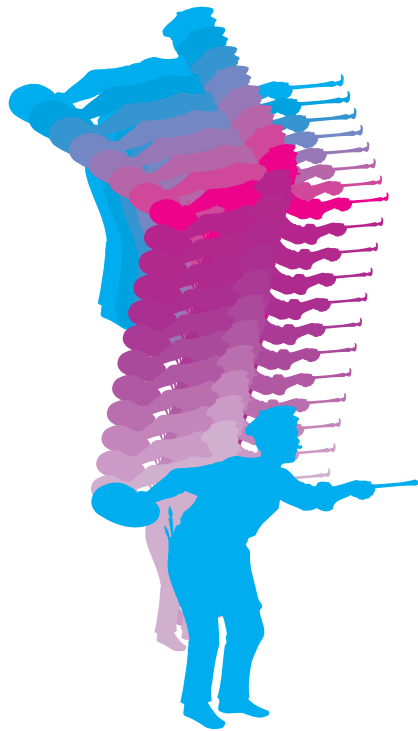
Casting a Wider Net

On many fronts, the housing-finance community has succeeded in marshaling new tools and outside assistance to clamp down on fraud. What's more, the industry's fraud-fighting capabilities should get another boost if pending federal regulations are enacted. The Federal Reserve Bank and the American Bankers Association together are drafting regulations that set tougher fraud-prevention standards and due-diligence practices for financial institutions. These rules are

expected to take effect in 1998.

Not even the most diligent preventive measures, though, can guarantee an impenetrable fraud defense. Preparing for the inevitable, the industry is bolstering its investigative forces to catch these criminals and is better equipping itself to pursue restitution. More than two-thirds of the lenders responding to a recent Mortgage Bankers Association survey reported that they employ personnel to investigate and resolve fraud cases.

The secondary mortgage market also can suffer at the hands of fraud practitioners. Just this summer, both the president and the sales manager of a now defunct mortgage company were convicted of defrauding Freddie Mac. The pair used straw buyers to disguise the purchase of investment properties and sold the fabricated mortgage loans to Freddie Mac. Detecting this type of fraud is difficult because the loan is processed by the originator to make it look as though the straw buyer is a legitimate borrower. Although the two defendants in this case have not yet been sentenced, they could receive prison terms of more than five years for their actions.



The efficiencies created by the secondary market depend on the accurate transfer of information and the contributions of reliable professionals. Incidents of mortgage fraud—which can lead to loan defaults and high financial losses—potentially could undermine the funding system's effectiveness.

Consequently, Freddie Mac took an early lead in the fraud-investigation and loss-recovery arenas. In 1989, the company created one of the first fraud-investigation units in the lending industry to better protect its investments. This team of mortgage professionals and former law-enforcement officials aggressively investigates and

pursues individuals who have committed fraudulent acts against the secondary-market company. The fraud unit also follows up on tips that come in through its toll-free fraud hotline, (800) 437-2838.

To further impede fraud, Freddie Mac has established a list of individuals and institutions now excluded from participating in the origination and servicing of loans for the company due to a demonstrated lack of business competence or integrity. The company's lending partners must screen their business contacts against those listed, all of which, in Freddie Mac's judgment, represent undue risk of loss. Otherwise, lenders may have to buy back the mortgages they sell to Freddie Mac in the event that an excluded person or company participated in the origination or servicing of those loans.

Freddie Mac's initiative is bearing fruit. Joint efforts between Freddie Mac and law-enforcement agencies have led to hundreds of indictments, 57 convictions, \$73.3 million in judgments and \$19 million in restitution since the fraud unit was established.

The successful pursuit and prosecution of scam artists largely depend on resources that typically are in short supply. Consequently, Los Angeles and some other cities have given high priority to funding fraud investigations and recovery efforts. In Los Angeles County

alone, residents lost more than \$183 million to mortgage swindles in 1993 and 1994, according to the San Francisco branch of Consumers Union. To help provide relief, Freddie Mac and the Mortgage Insurance Companies of America (MICA) gave the Los Angeles District Attorney's office a \$500,000 grant in July 1994 to fund a new unit dedicated to investigating and prosecuting cases of real-estate fraud. A law passed in 1996 has since given all California counties the option of assessing a \$2 recording fee on real-estate trust filings to fund similar investigation units.

Fighting the Good Fight

Given the lack of a foolproof system to prevent the dishonest, the unscrupulous and the greedy from targeting the industry, the complete eradication of mortgage fraud is close to impossible.

Nonetheless, expanded efforts by the housing-finance community to thwart fraud crimes are yielding encouraging results. As the industry continues to tighten its ranks, arm its personnel with information to mitigate fraud and aggressively pursue scam artists, the message it is sending is clear: Fraud perpetrators beware; we are watching. **SMM**

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ARM Payment Options, continued from page 2

respondents. Even though the interest rate on the 3/3 ARM changes every three years, lenders are not charging borrowers much of a premium for the extra certainty. The average starting rate of 6.9 percent on a 3/3 ARM exceeded the 3/1 ARM start rate by a mere 0.1 percentage point.

Despite the widespread supply of ARMs, demand has waned in the face of historically low interest rates on fixed-rate mortgages. In August, ARMs accounted for only 20 percent of total mortgage financing, according to the Federal Housing Finance Board.

To make ARMs more attractive to consumers, lenders typically offer these products with a starting rate discounted below the **fully indexed rate**. On a conforming, one-year ARM, lenders were giving up 2.8 percentage points of interest during the first year, coincidentally an amount equal to the margin. Consequently, borrowers were paying about the same interest rate as the U.S. Treasury for the first year.

Since Freddie Mac's last ARM survey, the average discount has increased by 0.1 percentage point to 0.2 percentage point for ARMs that at some point adjust annually and by a heftier 0.4 percentage point for the 3/3 ARM. (See "ARM Lenders Compete on Introductory Rates," *SMM*, December 1996.) As Exhibit 1 also shows, lenders are shaving off successively less from the introductory rate as the duration of the initial-payment period lengthens. Likewise, the interest-rate spread between adjustable-rate and fixed-rate mortgages narrows as the initial-rate period extends.

Additional calculations indicate much less deviance in the prices charged for fixed-rate mortgages. The interest rates quoted within ARM-product categories varied across lenders by up to three times that cited for fixed-rate mortgages, leaving a diligent ARM shopper a wide range of price points from which to select.

—**Michael Schoenbeck, financial analyst**