STAYING AHEAD OF THE PACK: EMERGING TRENDS & ISSUES
CURRENT TRENDS IN MORTGAGE FRAUD

In this ever-changing world of mortgage fraud, one thing is certain—fraud examiners must be on top of their game at all times. In this session, learn the emerging schemes and trends and how to identify red flags of this fraud. Protect your company and/or your clients from becoming unwitting victims or participants in mortgage fraud.

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Introduction
Gone are the boom days in the mortgage industry. Credit standards have tightened, creative loan products are gone, and the secondary market is shrinking. With the passage of the Dodd-Frank Wall Street Reform bill, along with joint regulators’ proposed rule making, the industry is undergoing significant change in the way residential mortgage loans are originated.

But does that mean mortgage fraud will decline? Not necessarily. Whenever there is the opportunity for large sums of money, along with perceived pressure (loss of income streams for many industry professionals) and the rationale to justify the behavior (I won’t get caught), fraud is alive and well, including in the mortgage industry. Mortgage fraud just mutates to fit the current mortgage environment.

How Big Is the Mortgage Fraud Problem?
It is hard to say how big the mortgage fraud problem is because there is no central reporting of mortgage fraud incidences. The primary indicator is the suspicious activity reports filed by lenders to the Financial Crimes Enforcement Network (FinCEN).

Suspicious Activity Reports
All financial institutions operating in the United States are required to report mortgage fraud activity through Suspicious Activity Reports (SARs). SARs were created in 1996 by joint regulation of the Department of the Treasury, the OTS, OCC, Federal Reserve, and the FDIC to assist with the detection of illegal activities and suspicious financial transactions. Federally insured depository institutions must submit SARs to the Financial Crimes Enforcement Network (FinCEN), which then distributes them to the appropriate
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| enforcement agencies. An institution subject to the SARs filing requirements must submit a report when it detects a known or suspected violation of federal law, a suspicious transaction related to a money laundering activity, or a violation of the Bank Secrecy Act. |

According to the *FinCEN Mortgage Loan Fraud Update—Suspicious Activity Report Filings from Jan 1 – Dec 31, 2010, released in March 2011*, depository institutions filed 70,472 mortgage loan fraud SARs (MLF SAR) in 2010, a 4 percent increase over 2009 filings. However, the actual incident rate of mortgage fraud is likely higher than reported because the government only gets reports from federally regulated institutions, which does not include non-depository mortgage lenders that are state regulated. Therefore, the fraud experiences of independent or state-regulated mortgage banking companies are not reflected in the FinCEN report.

Since 2001, the number of MLF SARs filed has shown a consistent upward trend, albeit at a slower rate of growth in recent years. One trend noted is the time lapse between the filing and the origination dates in 2010. MLF SARs showed a focus on older originations. For filing year 2010, a majority of the originations occurred two to four years prior to filing.

*Geographical Hot Spots*

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<td><strong>SARS FILINGS</strong></td>
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<td>According to the FinCEN Mortgage Loan Fraud Update—Suspicious Activity Report Filings from Jan 1–Dec 31, 2010, the following list shows the top-ranked states with the highest number of MLF subjects per capita:</td>
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<td>1. Nevada</td>
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### The Cost of Mortgage Fraud
In its 2009 Mortgage Fraud Report, the FBI reported that the losses attributed to mortgage fraud in 2009 were $2.8 billion, an 86 percent increase from FY 2008 and a 250 percent increase from 2007. SAR losses in the first six months of 2010 exceeded the same period in FY 2009 by more than $788 million. While total SAR losses in FY 2009 were $2.8 billion, only 22 percent of SAR filings reported a loss.

### Emerging Schemes
- **Origination Frauds**
  - Credit misrepresentation and manipulation
  - Debt ratio manipulation
  - Misrepresentation of borrower equity contribution
- **Servicing Frauds**
- **Frauds by Servicer**
- **Frauds Perpetrated at Servicing Stage**

### Creditworthiness
Going forward, a consumer’s credit score and willingness to repay will be crucial to obtaining a mortgage. One criterion used by lenders in basing their credit decision is “Will the consumer repay?” Any material misrepresentation, misstatement, or omission
related to the borrower’s true credit situation could constitute mortgage fraud.

• Altering the FICO credit score on the credit report
  – Alter the credit score after issuance from the credit bureau
  – Omit or alter the derogatory trade lines to justify the altered FICO score

• Credit-repair—“piggybacking”

• “Credit-for-Sale” straw borrower
  – Consumer who agrees, for a fee, to take out a mortgage loan on behalf of someone else
  – Only contribution is the ability to qualify using good credit and sign the legally binding documentation
  – Is told that someone else will make the payments and take care of all aspects of ownership
  – Think nothing is wrong with this

• Identity Fraud
  – Occurs when someone else’s name, Social Security number, and credit score are used to qualify for a loan unbeknownst to them

**Debt Ratio Manipulation**

Also central to new legislation and regulation is the requirement that loan originators verify a borrower’s ability to repay. Lenders use debt ratios as one indicator of a borrower’s ability to repay. Debt ratios are shrinking, forcing some consumers out of the market for a home.

Lenders use two debt ratios to base their credit decision.

• Top debt ratio = monthly housing expense / gross monthly income
  – Monthly housing expenses include:
    * First mortgage payment
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| * Real estate taxes and insurance (annual cost / 12)  
  * Homeowner association dues  
  * Second and third mortgage payment (if any)  
    - The proposed cap for a top debt ratio is 28 percent  
| Bottom debt ratio = (total monthly housing expense + recurring debt) / gross monthly income  
  - Any debt exceeding 6–10 months maturity (even if not appearing on a credit report)  
    * Car payments  
    * Charge card payments  
    * Child support  
    * Payments on installment and personal loans  
    * Any additional mortgage obligations  
    - The proposed cap for a bottom ratio is 36 percent  
| In order to meet this ratio requirement, misrepresentations are made:  
  - To lower the top ratio, income is overstated  
  - To lower the bottom ratio, debts are understated  

**Income and Employment Misrepresentation**

- Remains one of the most common misrepresentations  
- Misrepresent employment position and stability  
- Fabricate or alter income documentation  
- Internet sites  
- Fabricate rental income to qualify for new mortgage  
- Cell phone bank for verbal verification of employment  
- Going forward, employment and income must be verified  
- The use of IRS Form 4506T is required by Dodd Frank Act and likely characteristic of QRM  
- Abuses  
  - Overstate income on quarterly filing, and then file adjusted return
### Misrepresentation of Debts
- Alter the credit report to delete debts
- Omit debts that do not show up on credit report, or that are too new to show up on a credit report
- Fabricate reason to explain away a debt that shows up on a credit report
  - File a fictitious satisfaction of lien or judgment
  - Fabricate a phony “paid in full” receipt
  - Fabricate a letter of explanation that debt is the responsibility of an ex-spouse or other family member
  - Fabricate a HUD-1 showing the sale of a mortgaged property listed on a credit report
- Fail to account for additional debt obligation incurred the same day as subject mortgage (purchasing or refinancing multiple properties on the same day)

### Equity Contribution Misrepresentation
Lenders are requiring lower loan to value (LTV) for QRM, which equates to higher contribution of equity (skin in the game) from the consumer. History has demonstrated that the more equity a consumer has invested in his home, the less likely he is to allow his home to go into foreclosure.

The need to save and contribute a substantial down payment can price many out of the market for home ownership. Equity contribution misrepresentation involves misrepresenting the source of the borrower’s funds contributed to the transaction, which misleads the lender into believing the consumer has skin in the game. The transaction is presented to the lender as if the borrower is providing the funds, when in fact the funds are coming from some other source.
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When equity contribution is misrepresented, assets are typically fabricated/overstated in the qualifying documentation to mislead the lender that the borrower has the adequate funds to contribute.

- Misrepresent the verification of deposit sent to the depository bank
- Overstate balances on the borrower’s bank statement
- Deposit funds into borrower’s account prior to verification
- Add a borrower to the fraudster’s account

Another common misrepresentation is to mislead the lender that the property seller is already in possession of a substantial earnest money deposit.

Even though the settlement statement (HUD-1) shows the borrower bringing the funds, the funds are coming from another source.

- Property seller stating he has already received a substantial earnest money deposit that is listed on the HUD-1
- Perpetrator hands the borrower an envelope outside of closing with instructions to hand it to the closing agent/attorney
- Funds are deducted from the seller’s proceeds and credited toward the borrower’s funds to close
- Funds disbursed from the lender prior to receipt of borrower funds into escrow; the funds representing borrower funds received the following day

Another ploy to circumvent any borrower contribution of funds to close is to disguise the purchase transaction as a refinance.

- Don’t need to contribute equity for a refinance
- Appraisal must be inflated to “create” equity (10–20 percent)
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• Lack of lender “seasoning requirements” are manipulated and abused

Servicer Fraud/Servicing Fraud
The loan servicer is retained to service the loan throughout the term of the loan or repayment, whichever comes first. The loan servicer can be the following:
- The funding lender servicing its own portfolio
- The funding lender servicing loans sold to a secondary market investor
- A third party servicing the loan for the owner of the mortgage (lender or investor)

The servicer does not necessarily equate to the owner of the mortgage. Servicing is a for-profit business, and servicing rights can be sold independently of the mortgage ownership throughout the life of the loan. The sale of the servicing should be transparent, as the borrower should receive communication from both the old and new servicer.

Fraud Perpetrated by the Servicer
• Servicer misappropriates the borrowers’ payments
• Servicer misappropriates the custodial funds due to the owner of the mortgage
• Servicer fails to remit timely payoff to the owner of the mortgage
• Fraudulent means to repay second lienholder debt
• Fraudulent sale of mortgage notes
  - U.S. Mortgage serviced loans for credit unions
  - In order to address cash flow problems at U.S. Mortgage, owner sold these loans without the knowledge of the true owner (the credit unions) to a secondary-market investor
  - Used funds received from this sale; used it to fund the company’s operations and personal investments
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Fraud Perpetrated by Servicing Stage of the Loan

- Emerging fraud schemes are being perpetrated during the workout phase of servicing
- Workout specialists employed by the servicers are not versed in identifying red flags of fraud
- High volume, production environment
- Emerging schemes at servicing stage
  - Loan modification fraud
    * Borrower abuses
    * Third-party abuses
  - Short sale fraud
    * Eligibility misrepresentation
    * “Short Sale and Stay”
    * Short sale flopping

Loan Modification Programs

- General eligibility requirements
  - First lien, owner-occupied properties secured by loans originated prior to 1/1/09
  - No cash-out with loan limit less than $729,750 (1-unit)
  - Delinquent borrowers must demonstrate hardship
  - Must have mortgage debt-to-income greater than 31 percent
  - Properties that are abandoned, vacant, or condemned are not eligible
- No cost for modification

Loan Modification Fraud

- Borrower abuses:
  - Feigning hardship
  - Understating income and assets (reverse income misrepresentation)
  - Occupancy misrepresentation
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- The misrepresentation occurs as the lender relies on misinformation in basing its decision to modify with less profitable terms.
- Third-party abuses
  - Engaging an authorized third party (modification specialist) that charges a fee to the borrower in promising to obtain a modification on their behalf
    * Strategic defaults
    * No contact with the servicer
    * No service provided
  - Loan modification specialists using borrower information obtained via the loan modification process to perpetrate ID fraud on other mortgages

### Short Sale Frauds

A short sale involves an agreement whereby the servicer (for the lender or investor) allows the homeowner to sell his property for less than the mortgage owed.

- Occurs at the servicing stage
- Can be a viable option to foreclosure for both the holder of the note and the borrower
- Short sales have increased 300 percent from first quarter 2008 to first quarter 2009
- The risk of fraud is reported in 1 of 53 short sales
- Short sales have provided the fraudsters a plentiful inventory to use in short sale schemes, and lenders are motivated to move non-performing loans off their books
- Estimated lenders incur an unnecessary loss of $310 million; average loss is $41K per transaction

Short sale frauds to be discussed include:
- Eligibility misrepresentation
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- **“Short Sale and Stay”**
- Short sale flopping

#### ELIGIBILITY MISREPRESENTATION
Similar to loan modification fraud, a borrower misrepresents his hardship to qualify for a short sale
- Income misrepresentation
- Strategic default

#### “SHORT SALE AND STAY”
- Used by homeowners facing foreclosure to *keep* their home and lower their debt obligation
- Borrower, either acting alone or through a short sale negotiator or other industry insider, lines up a nominee buyer, often a family member, who poses as a legitimate short sale buyer
- Incumbent on *under-valuation* of the property
- Servicer agrees to the short sale based on the misrepresentation of the relationship between the homeowner (seller) and buyer
- Owner stays in the home; thinks debt is forgiven
- Loan to straw is much lower than original debt; payments are much less
- The alleged misrepresentation is that the holder of the note loses out on a legitimate recovery of the asset as the servicer sold the property based on the reliance of a misrepresentation made in regard to an undisclosed relationship and/or agreement between the parties

#### “SHORT SALE FLOPPING”
- Short sale flopping is a variation on property flipping
- Property flipping is not illegal but can become problematic when the value on the second transaction cannot be justified
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- Short sale flopping involves the immediate sale of a short sale property at an unjustified increase in value
  - But instead of *inflating* the value on the second transaction, the value on the first transaction is *deflated*
- Many problematic short sale flops involve a short sale negotiator (SSN), a new industry profession
- There has been a migration of real estate agents that now specialize in negotiation
  - Some states require licensing of SSN
  - A licensed real estate agent is in an advantageous position to orchestrate a short sale flop, but also has an implied duty to the homeowner (seller) that is often abused
- In problematic short sale flops, it is often not the borrower who orchestrates the flop; it typically involves a third-party SSN
- The SSN targets a distressed homeowner with an alternative to foreclosure by offering to negotiate with the servicer and find a buyer
- SSN receives third-party authorization from homeowner to negotiate on his behalf with the lender
  - Often instructs homeowner to quit making mortgage payments and stop all future contact with the servicer
  - Implied fiduciary duty to negotiate in the best interest of the homeowner and secure the highest sales price based on fair market value
  - The Federal Trade Commission has recently issued regulation for providers of any foreclosure alternative services requiring strict disclosures
- SSN executes, or causes to have executed, a listing agreement to market the property to the open market to find the highest and best offer

### NOTES
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* SSN might not list the property, as a nominee buyer has already been identified (often himself)
  * Fiduciary duty is to someone other than the homeowner
    - Executes purchase contract under name of LLC or through a nominee buyer at arbitrary low price
    * Often uses an option contact, allowing wiggle room should the flop not materialize
    * Presents his offer as the highest and best offer, when in fact it is the only offer
    - Concurrently, SSN is advertising (or listing) the property for sale to an end buyer
      * Represents nominee as the owner on this listing—even before nominee has acquired the property
      - The SSN influences the valuation that the lender relies on in making his decision
        * Broker Price Opinion (BPO) is customarily used to establish fair market value
        * Absent ability to conduct the BPO himself; will engage in various tactics to ensure value is lowballed
      - The lender agrees to the short sale based on the following misrepresentation, misstatement, or omission:
        * Non-disclosure of the higher, subsequent sale that will close immediately after the short sale
        * Value deflation—undue influence on the valuation process
      - The alleged misrepresentation is that the mortgage owner loses out on a legitimate recovery of the asset based on the failure to disclose the subsequent offer/sale at the higher price and the intentional misrepresentation of value

In a traditional property flip, it was not unusual for the second transaction (B/C) to close first, thereby
using the end buyer’s loan proceeds as the vehicle for the SSN/perpetrator to purchase the property in the A/B transaction. This allows the fraudster to perpetrate this scheme with little or no monetary involvement.

- Today, many lenders and title insurers allow back-to-back closings, with clear instructions for the A/B to close first
- However, many lenders and title insurers have no “seasoning” requirements that ownership in a property be seasoned before it is resold
  * A property can be vested in one person’s name for one minute and still be eligible for a purchase-money loan to a new buyer
  * On 2/1/10, HUD temporarily suspended its 90-day seasoning requirement through Dec 2011
  * Dough-for-a-Day companies and proof of funds generators

The success of the short sale flops lies in the undervaluation of the asset, which generates greater profit spread between the two transactions. Absent the ability to conduct the BPO, a SSN might resort to any means possible to persuade the BPO agent to lowball the value, upon which the lender relies.

- MLS manipulation
- Comparable shopping and identification
- Reverse staging
- Phantom repairs and property “stigma”