interthinx
A Verisk Analytics Company

2010 Annual Mortgage Fraud Risk Report

In depth analysis of nationwide risk as indicated by the Interthinx® Fraud Risk Indices

Executive Summary

This report highlights some of the most significant mortgage fraud risk trends based on analysis of loan applications processed in 2010 by the Interthinx FraudGUARD® system.

- The states with the highest overall levels of mortgage fraud risk corresponded closely to the states with the highest levels of foreclosure activity and underwater borrowers. The strong correlation between mortgage fraud risk and foreclosure activity is consistent with the increase in fraud schemes that seek to take advantage of opportunities presented in distressed markets, such as "flopping" (deflating short sale values in order to generate a profit margin on a subsequent flip at an increased value), and foreclosure rescue-related schemes.

- As of Q4 2009, fraud risk levels in Nevada and California were nearly identical with California's overall risk index value at 222 and Nevada's value at 220. However, during 2010 their risks diverged, with Nevada's overall risk index value increasing to 255 while California's decreased to 180. This may be due to a migration of fraudsters seeking to take advantage of the more fertile grounds for fraud in Nevada, where the proportion of foreclosure and distressed sales is by far the highest in the nation.

- The overall level of risk in the Chicago metropolitan statistical area ("MSA") increased dramatically in 2010, rising from 134 in Q4 2009 to 185 in Q4 2010. This increase seems to have originated and spread from zip code 60621, which at the end of 2009 was the only zip code in Chicago with an index value in excess of 375. This localized risk spread throughout the metropolitan area during 2010 to the extent that by Q4 2010, numerous Chicago zip codes had index values greater than 375. Moreover, four of the 20 most risky zip codes nationwide in 2010 were located in Chicago. These findings demonstrate the need to analyze aggregated loan application data at granular levels in order to help identify hot spots and to determine which additional controls might help contain the geographic expansion of risk.

- The Employment/Income and Identity Fraud Risk Indices both rose by nearly 30% over the last year, which may indicate that the incidence of so-called "fraud for property" is on the increase. Frauds "for property" have largely been ignored by the industry and law enforcement because of the belief that they are "one-offs" that rarely default. However, "frauds for property" were the predominant form of mortgage fraud during the boom and rather than being harmless "one-offs," this type of fraud enabled millions of borrowers to obtain loans they could not afford to repay. When these borrowers began to default *en masse*, it sparked the "mortgage meltdown", which led to the failure of hundreds of financial institutions, the liquidity crisis, and, ultimately, the Great Recession. Seen from this perspective, it is clear that frauds "for property" must be identified and addressed going forward with the same urgency as frauds "for profit."

Fraud Risk and Foreclosure/Distressed Sales

Figure 1 shows the 2010 Mortgage Fraud Risk Index for the individual states, with the ten highest risk states shown in red. The most risky states were Nevada, Arizona, California, Michigan and Florida – all of which experienced extremely difficult conditions including high unemployment and foreclosure rates and extreme drops in property values over the last few years. The top ten is rounded out by Colorado, Minnesota, Georgia, Rhode Island, and Massachusetts. In addition to the top ten states, the District of Columbia, Maryland, New Jersey, Tennessee, Ohio, Illinois, Oregon and Hawaii also have index values above the national value of 144 (n =100). The ten states with the lowest risk, shown in green, were Kansas, West Virginia, South Dakota, Mississippi, Maine, Wyoming, Alabama, North Dakota, and Louisiana. The five least risky states have index values of less than half the national value.

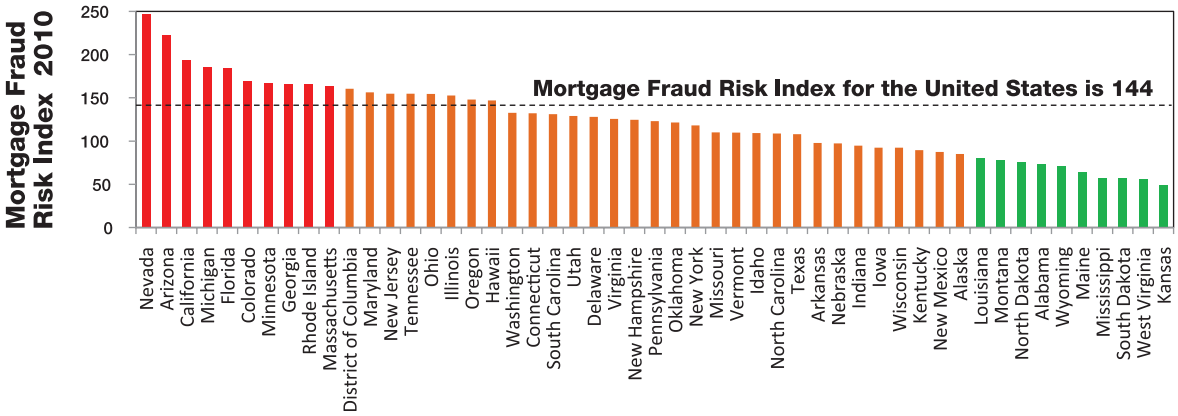

Figure 1: Mortgage Fraud Risk Index 2010 by State

Figure 2 shows mortgage fraud risk and the proportion of foreclosure sales in each state. The color represents the proportion of total home sales that are foreclosures, with darker colors depicting higher levels of foreclosure sales, and higher relief indicating a higher level of fraud risk. The strong correlation between regions with mortgage fraud risk and foreclosure activity is clear: Nevada and Arizona, which in 2010 had the highest mortgage fraud risk index values of 247 and 222, respectively, also had the highest levels of foreclosure sales at 57 percent and 49 percent of all sales, respectively. The other states in the top five in terms of fraud risk (California, Michigan and Florida) also round out the top five in terms of foreclosure sales. The correlation between mortgage fraud risk and level of foreclosure sales is consistent with the increase in fraud schemes that seek to take advantage of opportunities presented in distressed markets, such as “flopping” (deflating short sale values in order to generate a profit margin on a subsequent flip at an increased value), and

foreclosure rescue-related schemes. It is important to note that the top ten states were also frequent entrants on Interthinx's top ten overall fraud risk lists during the early boom years (2003 to 2004) and, foreshadowing the crisis to come, began to experience elevated levels of foreclosure activity largely unrelated to economic conditions between 2005 and 2007. Current risk levels in these states thus represent a second wave of concentrated fraudulent activity.

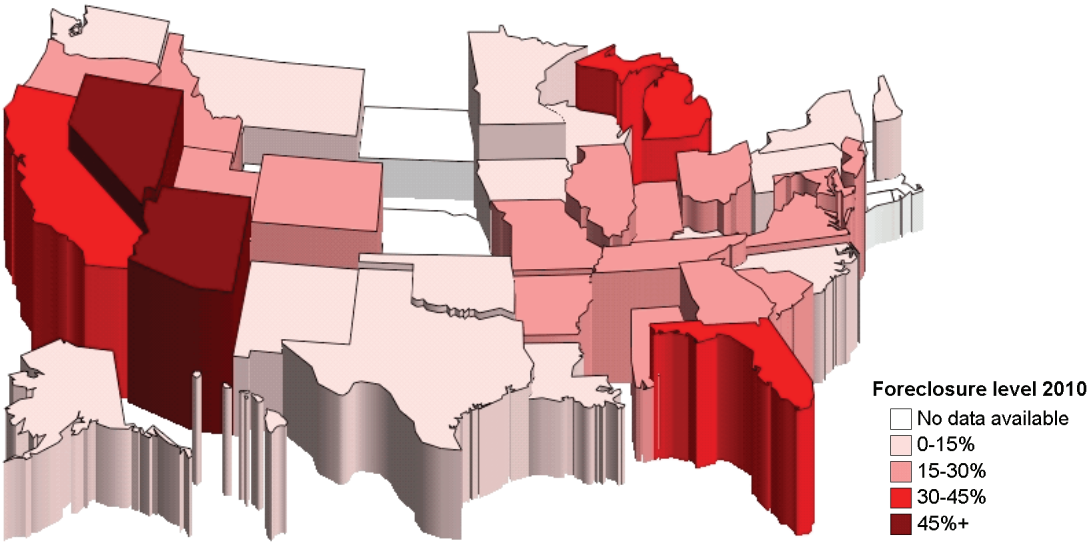

Figure 2: Nationwide Foreclosure Activity[1] and Mortgage Fraud Risk 2010

The increased occurrence of flopping schemes is further confirmed by an analysis of the historical incidence of repeat sales with large positive price movements over a short period of time, which, during the boom, was a strong indicator of illegal flipping. These indicators occurred very frequently between 2003 and 2005, coincident with the peak in home price appreciation rates. Flipping indicators dropped in 2006 as interest rates began to rise and housing price appreciation slowed, and then bottomed out in 2008 as the liquidity crisis took hold. Although these indicators have been rising since 2009 they remain well below peak levels and are now likely associated with short sale flopping schemes, where the first sale occurs at an artificially depressed below-market value followed by a quick or simultaneous resale at or near actual market value. This trend is not surprising in view of the proliferation of Federal, GSE and proprietary programs that encourage short sales as an alternative to foreclosure.

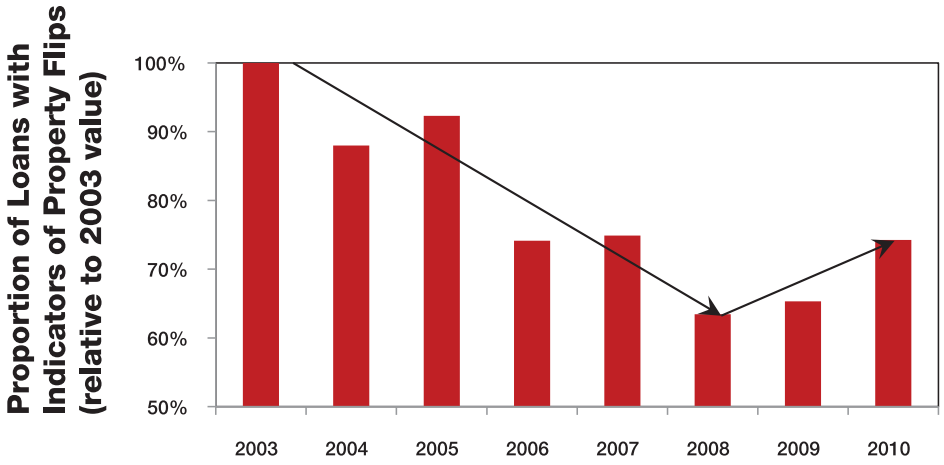

Figure 3: Proportion of Loans with indicators of "Flipping" (2003-2008) and "Flopping" (2009-2010)

Fraud Risk Migration Between Nevada and California

Mortgage fraud risk migrates geographically as perpetrators seek to take advantage of local market conditions, as exemplified by 2010 fraud risk trends in California and Nevada. Fraud risk in Nevada and California started the year at nearly identical levels, with California's fraud risk index value at 222 and Nevada's at 220 in Q4 2009. However, their risks diverged in 2010 with Nevada's increasing to 255 while California's decreased to 180 as shown in Figure 4.

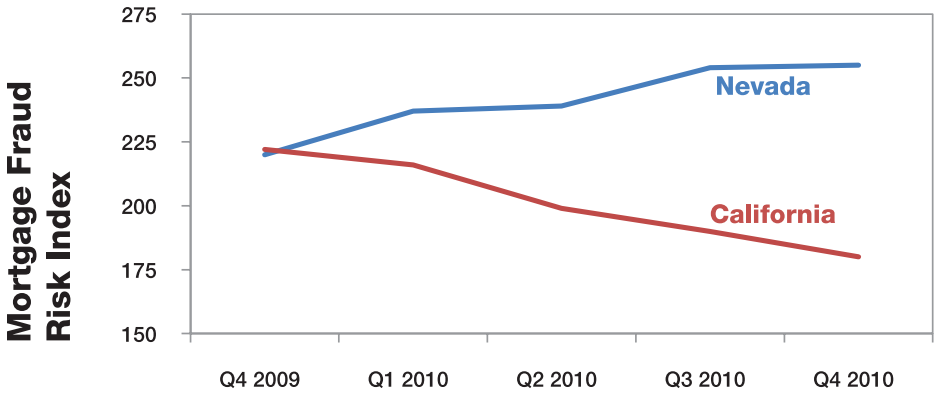

Figure 4: Change in the Mortgage Fraud Risk Index in California and Nevada

This is further illustrated in Figure 5, which shows the distribution of fraud risk at the zip code level in these two states for Q4 2009 and Q4 2010. While California's Central Valley region remains at very high risk, the risk along the coast has decreased. During this same period fraud risk in Nevada increased dramatically, particularly in Las Vegas, its primary population center. This increase in risk is evident from the fact that while there were no Nevada zip codes in the highest risk band in Q4 2009, there were a large number of zip codes in that category by Q4 2010.

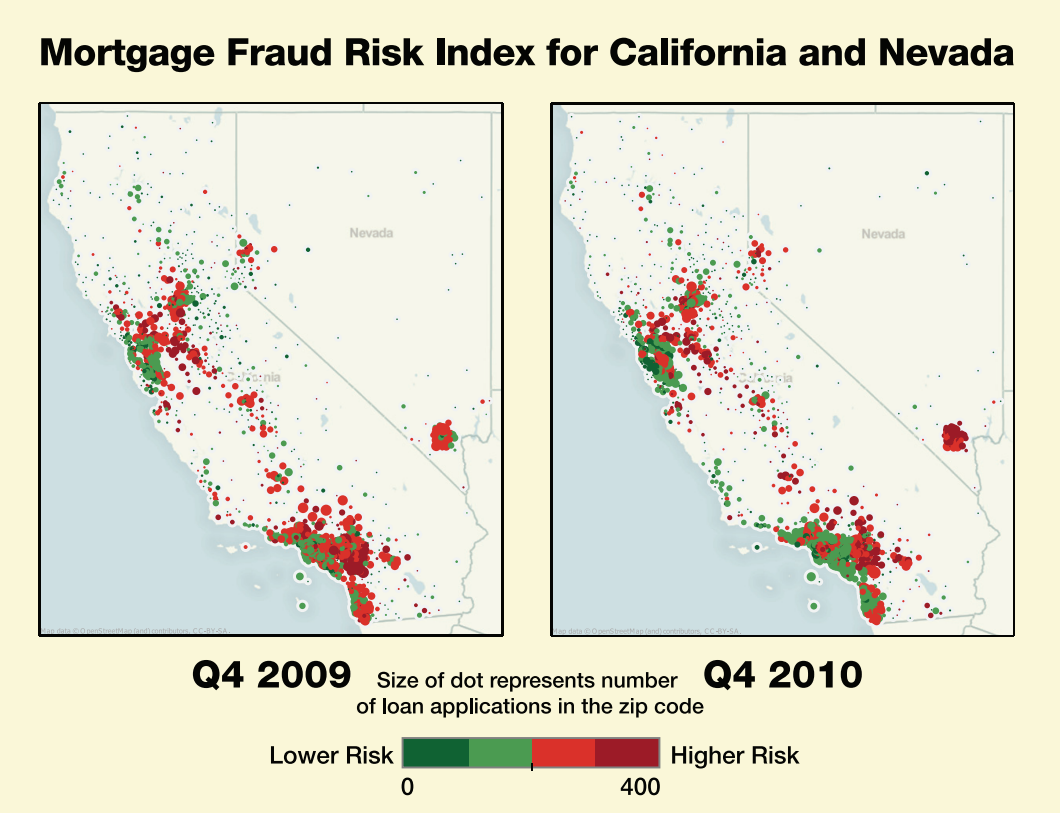

Figure 5: Mortgage Fraud Risk Index in California and Nevada at zip code level

It should be noted that despite the clear reduction in overall fraud risk in California the risk levels in the state remain elevated, as illustrated by Table 1, which shows that seven of the top ten, and 12 of the top 20 MSAs in the nation are located there. The vast majority of these MSAs are located in the Central Valley region which includes Merced, the most risky MSA with a Fraud Risk Index value of 368.

Rank	Metropolitan Statistical Area	Mortgage Fraud Risk Index 2010
1	Merced, CA Metro	368
2	Modesto, CA Metro	275
3	Vallejo-Fairfield, CA Metro	273
4	Stockton, CA Metro	266
5	El Centro, CA Metro	264
6	Las Vegas-Paradise, NV Metro	260
7	Riverside-San Bernardino-Ontario, CA Metro	260
8	Madera-Chowchilla, CA Metro	252
9	Cape Coral-Fort Myers, FL Metro	248
10	Phoenix-Mesa-Scottsdale, AZ Metro	237
11	Fresno, CA Metro	235
12	Salinas, CA Metro	234
13	Yuba City, CA Metro	227
14	Visalia-Porterville, CA Metro	226
15	Detroit-Warren-Livonia, MI Metro	224
16	Napa, CA Metro	222
17	Lake Havasu City-Kingman, AZ Metro	218
18	Bakersfield, CA Metro	216
19	Miami-Fort Lauderdale-Pompano Beach, FL Metro	214
20	Yuma, AZ Metro	214
69	Chicago-Naperville-Joliet, IL-IN-WI Metro	160

Table 1: MSAs with the Highest Fraud Risk in 2010

Spread of Risk in Chicago

One of the most noteworthy trends of 2010 was the spread and elevation of fraud risk levels in the Chicago MSA. As noted in Table 1, the Chicago MSA (highlighted in yellow) had a relatively moderate risk level in 2010 with a Mortgage Fraud Risk Index value of 160 and a rank of 69 out of 366 MSAs. However, Table 2, which shows the most risky zip codes in the nation, reveals a completely different picture: three of the top six and four of the top 20 zip codes are located in Chicago.

Rank	Zip Code	City, State	Mortgage Fraud Risk Index 2010
1	48320	Keego Harbor, MI	533
2	33976	Lehigh Acres, FL	484
3	60621	Chicago, IL	468
4	93635	Los Banos, CA	458
5	60636	Chicago, IL	456
6	60624	Chicago, IL	422
7	33971	Lehigh Acres, FL	406
8	95341	Merced, CA	385
9	95348	Merced, CA	384
10	95368	Salida, CA	382
11	30310	Atlanta, GA	381
12	92553	Moreno Valley, CA	376
13	95363	Patterson, CA	376
14	48310	Sterling Heights, MI	370
15	94585	Suisun City, CA	367
16	85303	Glendale, AZ	366
17	80219	Denver, CO	362
18	92376	Rialto, CA	358
19	60623	Chicago, IL	354
20	91768	Pomona, CA	354

Table 2: Zip codes with the Highest Fraud Risk in 2010

It appears that the increase in risk in Chicago was driven by very localized risks spreading to adjacent areas and subsequently throughout the MSA. The change in fraud risk in Chicago at the zip code level over the last year is shown in Figure 6. In Q4 2009, the 60621 zip code was in the highest risk band with an index value of 458 – more than 120 points higher than second place 60609. Since then fraud risk has spread more widely throughout the Chicago MSA with multiple zip codes having indices in the highest risk band. A closer examination shows that the increase in risk began with zip codes that were located close to 60621.

It is also worth noting that between Q4 2009 and Q4 2010 the index value for 60621 increased 24 percent but the geographic spread of fraud risk throughout Chicago has increased the MSA-level index value by 38 percent. These findings demonstrate the value of analyzing aggregated loan application data at granular levels in order to help identify hot spots and to determine which additional controls might help to contain the spread of risk.

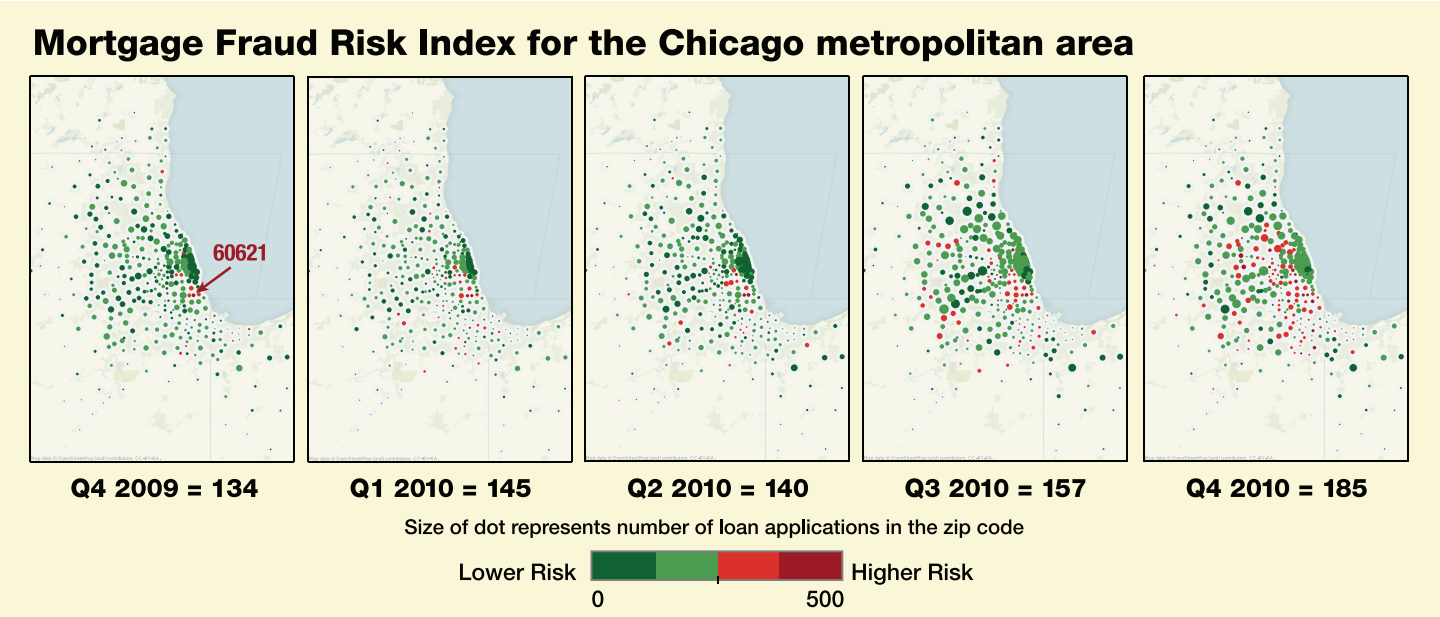

Figure 6: Zip Code level map of Chicago MSA Fraud Risk Q4 2009 to Q4 2010

Increase in Fraud for Property

Figure 7 shows that while the overall Mortgage Fraud Risk Index decreased by three percent in 2010 as compared to the year before, two of the type-specific fraud risk indices – Identity and Employment/Income – rose by nearly 30 percent.

The increase in these two indices is an indication that so-called 'fraud for property' is on the rise as friends and family take on debt in order to help those with lower incomes and/or impaired credit histories obtain housing following a foreclosure.

Many lenders, some fraud "experts," and the FBI classify mortgage fraud as either being "for profit" or "for property" and have generally focused their attention on large "for profit" schemes. This is due in part to the mistaken belief during the boom that the overall incidence of frauds for property were insignificant, that they were "one-offs," and that they were not worth pursuing because the borrowers intended to repay their mortgages and thus that they were unlikely to default.

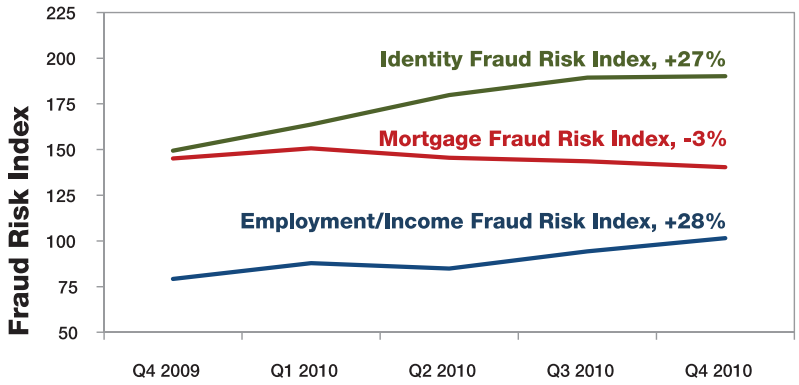

Figure 7: Change in the Mortgage Fraud Risk, Identity Fraud Risk and Employment/Income Fraud Risk Indices

The reality is that fraud "for property" was the predominant form of mortgage fraud during the boom. Suspicious Activity Reports submitted to the Financial Crimes Enforcement Network list the borrower as the subject in fully two-thirds of all SARs filed over the past ten years.[2]

Forensic investigations by Interthinx and others into defaulted loans show that fraud "for property" committed during the boom, primarily through stated income and low- and no-document loan programs, enabled millions of borrowers to obtain loans they could not afford to repay. When these borrowers began to default *en masse* it sparked the "mortgage meltdown," which led to the failure of hundreds of financial institutions, the liquidity crisis, and, ultimately, the Great Recession.

Furthermore, frauds "for property" look like isolated incidents only when viewed at the individual loan level. A closer analysis reveals that the same mortgage brokers, real estate agents, and other professionals are often involved in multiple fraudulent transactions involving "creative financing" and/or misrepresentation of borrower qualifications. These professionals encourage borrowers to lie, or lie on their behalf, so that the loans will close and the professionals will make their commissions and fees. Seen from that perspective the distinction between fraud "for profit" and "for property" is specious. When viewed in the aggregate and in hindsight, it is clear that frauds "for property" posed a significant threat to the economy and that going forward, they must be identified and addressed with the same urgency as frauds "for profit."

Extended Forecast

Fraud risk continues to evolve as lenders and fraudsters alike adapt to changing economic conditions and government regulations. By instituting new processes and procedures, lenders have greatly reduced risk in originations. Going forward, the challenge will be to apply this knowledge and lessons learned to servicing and loss mitigation departments – the areas with the greatest risk exposure for the foreseeable future.

References

1. RealtyTrac: 2010 Year-End and Q4 Foreclosure Sales Report

2. Statement of James H. Freis, Jr., Director, Financial Crimes Enforcement Network, Before the United States House of Representatives Committee on Financial Services Subcommittee on Housing and Community Opportunity, May 6, 2009 http://www.fincen.gov/news_room/testimony/html/20090506.html

About the Interthinx Fraud Risk Indices

The Fraud Risk Indices are calculated based on the frequency with which indicators of fraudulent activity are detected in mortgage applications processed by the Interthinx FraudGUARD® system, a leading loan-level fraud detection tool available to lenders and investors.

The Interthinx Fraud Risk Indices consist of the Mortgage Fraud Risk Index, which measures the overall risk of mortgage fraud, and the Property Valuation, Identity, Occupancy and Employment/Income Indices, which measure the risk of these specific types of fraudulent activity.

The Mortgage Fraud Risk Index considers 40+ indicators of fraudulent activity including property mis-valuation; identity, occupancy and employment/income misrepresentation; non arms-length transactions; property flipping; straw-buyers; “silent seconds”; and concurrent closing schemes. The four type-specific indices are based on the subset of indicators that are relevant to each type of fraudulent activity.

Each Index is calibrated so that a value of 100 represents a nominal level of fraud risk, a value calculated from the occurrence of fraudulent indicators between 2003 and 2007 in states with low foreclosure levels. For all five indices, a high value indicates an elevated risk of mortgage fraud and each Index is linear to simplify comparison across time and location.

The Interthinx Indices are leading indicators based predominantly on the analysis of current loan originations. FBI and FinCEN reports are lagging indicators because they are derived primarily from Suspicious Activity Reports (SARs), the majority of which are filed after the loans have closed. The time lag between origination and the SAR report can be several years. For this reason, the Interthinx Fraud Risk Indices’ top geographies and type-specific findings may differ from FBI and FinCEN fraud reports.

The Fraud Risk Indices are calculated based on the frequency with which indicators of fraudulent activity are detected in mortgage applications processed by the Interthinx FraudGUARD® system, a leading loan-level fraud detection tool available to lenders and investors, in the time frame covered by the report.

About the Interthinx Mortgage Fraud Risk Report

The Interthinx Mortgage Fraud Risk Report represents an in-depth analysis of residential mortgage fraud risk throughout the United States as indicated by the Interthinx Fraud Risk Indices. Published quarterly, with a special Annual edition, Interthinx will, as part of the Fraud Risk Report, identify the geographic regions with the highest Mortgage Fraud Risk Index as well as those with the highest Property Valuation, Identity, Occupancy, and Employment/Income Fraud Risk Indices. The Interthinx Fraud Risk Indices track these risks in all States, Metropolitan areas, Counties and county equivalents, throughout the United States.

About Interthinx

Interthinx, a Verisk Analytics subsidiary, is a leading national provider of comprehensive risk mitigation solutions focusing on mortgage fraud, collateral risk and valuation, regulatory compliance, forensic loan audit services, loss mitigation, and loss forecasting. With more than 20 years of experience in customizable risk evaluation technology, Interthinx offers proven and effective predictive analytics to the residential mortgage industry through its experience with millions of loan applications and fraud incident data from thousands of monthly loan reviews. Throughout the mortgage life cycle, the Interthinx suite of services can increase the value of client portfolios with its comprehensive and holistic approach to loan quality and compliance. Winner of multiple awards for technology, Interthinx helps clients reduce risk, increase operational efficiencies, satisfy regulator demands, manage data verification, remain compliant, and mitigate loan buybacks. The Interthinx quarterly Mortgage Fraud Risk Report is a standard for the financial services industry. For more information, visit interthinx.com or call 1-800-333-4510.

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