

# Evolving Fraud Schemes Call For New Tactics

As the housing market changes, new mortgage fraud scams are becoming prevalent.

By Kevin Coop

In the wake of the economic crisis, an enormous amount of time, attention and money has been spent attempting to identify the root causes of the near collapse of the U.S. financial system. In its final report, the Financial Crisis Inquiry Commission stated that the crisis resulted from the “systemic failure” of prudential regulators and the financial services and securitization industries to question, understand and manage the evolving risks posed by residential mortgages.

Although regulators saw a problem on the horizon in 2006, when an interagency guidance dealing with non-traditional mortgages was released, the “fixes” did not begin in earnest until shortly after the markets froze in 2008. These fixes include enhanced originator assessment standards from the ratings agencies, Fannie Mae’s Loan Quality Initiative, the Federal Housing Administration’s (FHA) anti-fraud initiatives and the Dodd-Frank Act’s Qualified Residential Mortgage - all of which focus on improving loan quality.

More regulations in this vein can be expected when the Consumer Financial Protection Bureau - whose mandate includes nonbank lenders and mortgage servicers - begins operations in July. At the center of these new requirements is the recognition that the sustainability of loans depends on having accurate information from which to assess the borrower’s

qualifications and the value of collateral properties.

In other words, data integrity matters because it is the foundation for loan quality.

The good news is that loan originators have already made remarkable progress in reducing errors and inaccuracies in loan applications, in part because of their experiences with loan failures caused by fraud during the boom. By aggressively training their personnel in the analysis of the “four C’s” of good underwriting - credit, collateral, capacity and character - lenders have successfully raised the

quality bar and significantly reduced the number of fraudulent loans that slip through the originations process.

The bad news is that those who seek to “game” the system are constantly shifting their targets and strategies to take advantage of market opportunities and process weaknesses. In today’s economy, they seek to exploit distressed borrowers and properties partly because there are literally millions of opportunities, but mostly because it is an effective strategy.

The fraudsters are succeeding because they have correctly identified the industry’s current weakest links: default servicing and loss mitigation.

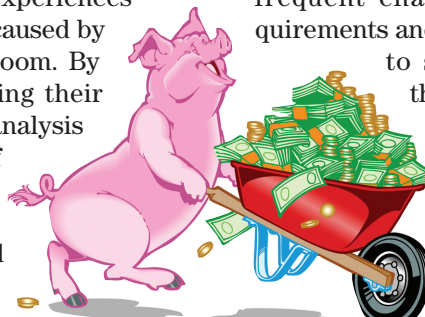
Today, the markets that are at the highest risk for fraud are also the markets with the highest numbers of underwater borrowers, short sales and foreclosures.

In addition to the widely publicized challenges involving unprecedented volume, there is also the stress of training employees to keep up with frequent changes in program requirements and the political pressure to single-handedly solve the ongoing foreclosure crisis. Furthermore, there is an extraordinary amount of internal and external pressure to complete as many modifications and short sales as possible within increasingly short turn times.

In response, servicers and loss mitigation departments run the risk of taking shortcuts that would produce transactions with quality problems similar in scope to the originations made in 2005 and 2006.

In such an environment, even basic risk management controls are largely non-existent, which is not surprising, because up until the foreclosure and economic crises hit, servicers’ duties were primarily administrative and clerical. In the good old days, fraud detection and prevention was not viewed as being necessary or required.

Forensic default investigations in-



to loans originated during the boom show that unchecked fraud has cost lenders hundreds of billions of dollars. While it is unlikely that losses in current originations will approach that level, fraud prevention must be prioritized today, because borrower deficiencies and secondary-market investor losses are being compounded by fraud, and because the investor with the most to lose is the federal government - and, by extension, U.S. taxpayers.

Whether it is a loan insured by the FHA, a loan owned by the government-sponsored enterprises or a loan for which the servicer receives incentive payments under the Making Home Affordable programs, the servicer is, directly or indirectly, dealing with federal funds. Thus, fraud in short sales, modifications, refinancings and originations is, arguably, fraud against the U.S., and servicers that ignore fraud may risk running afoul of the False Claims Act, the Theft or Bribery Concerning Programs Receiving Federal Funds Act and the Major Fraud Against the United States Act. Penalties under these laws can be severe: Under the Civil False Claims Act, those who are found guilty can face damages that are three times the government's actual losses; under the criminal fraud and theft statutes, the punishment tops out at \$10 million in fines plus up to 10 years' imprisonment.

Because the secondary market has always had a profound impact on quality control in the mortgage industry, public and private investors must be aware of what current schemes look like and must demand that servicers implement effective risk controls.

### ***Phony distress***

Fraud schemes are constantly shifting to take advantage of market conditions and process weaknesses within the industry. Over the past year, that fraud risk has been the greatest in the markets with the highest levels of underwater borrowers and foreclosure activity. These miscreant activities can involve short sales, foreclosed properties and flipping, identity-related frauds

and misrepresentation of borrower qualifications.

Fraudsters use information asymmetry to complete their crimes. Today's criminals create asymmetry by withholding and misrepresenting information that is material to determining collateral prices and values, ownership and intended use in short sales; affirmatively misrepresenting borrower identity, income and employment, and collateral value in loan modifications and refinancings; and fabricating supporting documentation.

Take short-sale fraud, for example. The property-acquisition phase of a typical short-sale fraud begins with finding distressed borrowers. Cynical profiteers are able to identify vulnerable homeowners by paying real estate agents for referrals and/or promising additional listings, sales and commissions; reading notices of default and foreclosure in the local newspaper; or marketing over the Internet, by direct mail or face-to-face "cold calls."

Once a candidate has been located, the offender (who may be the real estate agent) works to persuade the homeowner that a short sale is the best solution to his or her problems. When the owner agrees, the next task is to gain control of the negotiations with the owner's lender or servicer.

This can be accomplished by getting the borrower's written permission to act on his or her behalf, or by convincing the borrower to deed the property to a land trust with the perpetrator as trustee. The borrower may then be instructed to have no further contact with the servicer, to begin making payments to the perpetrator instead of to the servicer, or to stop making payments altogether.

Here are some tell-tale red flags:

■ A borrower with the ability to pay suddenly stops making payments, and the servicer receives an offer for a short sale shortly after a default is declared;

■ A borrower in default suddenly stops interacting with servicing or loss mitigation personnel, says he has been instructed to have no further communications or otherwise indicates that someone else is responsible for communications;

■ An unlicensed third-party intermediary makes contact on the borrower's behalf; or

■ The current title report shows recent transfer to a land trust.

Now, here are the best practices that can be taken to avoid these red flags:

■ Require that an arms-length affidavit be executed by the seller(s), the buyer(s), the real estate agent(s), and the settlement agent;

■ Escalate files where non-arm's-length transactions and undisclosed affiliated businesses are suspected or confirmed; and

■ If confirmed, place the participants' names on internal watch or exclusionary lists, as appropriate.

If the offender needs to create a profit margin on the property's resale to an end buyer, who often has agreed to purchase the property even before the start of the short-sale negotiations, the perpetrator will need to drive the short-sale price down as low as possible.

The first step is to instruct the owner to defer all physical maintenance and yard work, or to actively inflict minor or cosmetic damage. The crook may bypass the owner and simply bribe the agent preparing the broker price opinion to accept the perpetrator's list of "comparable" sales - which, in reality, are neither comparable properties nor actual sales, or will falsely claim that the property was used to, for instance, manufacture methamphetamine.

If the real estate agent is actively participating in the fraud, an artificially low asking price may be published in the multiple listing services, the property's neighborhood code may be misrepresented in order to give the appearance that the property is in an area with much lower values, the agent may not list the property at all and convince the lender to agree to a lower price "since no one's offering anywhere near what we're asking," or the agent may simply withhold higher offers from legitimate buyers.

In extreme cases, the perpetrator may conduct extensive negotiations and then, only a few days before the short sale is due to close, announce that the original buyer (who may

have been fictitious to begin with) is now either unable or unwilling to complete the purchase. The perpetrator then says, for example, that a substitute all-cash buyer has been found, but in order to close the sale, the price must be reduced by \$10,000 or more.

Obviously, the red flags here involve the following:

- A purchase contract that states the intent to resell;
- A title report that shows recorded purchase options; and
- A title that was transferred to a limited liability company (LLC) or trust within the previous six months.

The best practices to avoid this situation include the following:

- Ordering either a conditioned valuation model or a broker price opinion from an independent agent;
- Reading the purchase contract to identify whether the buyer is a relative;
- Reading the purchase contract to identify whether the buyer intends to resell the property - and, if yes, escalate file review to determine whether an "end" buyer has already been identified; and
- Escalating all files with "last minute" substitutions of the buyers, properties with recent transfers to LLCs or trusts, or recorded purchase options.

### ***Cash in hand***

An increasing number of short-sale acquisitions involve cash transactions. Perpetrators that do not actually have the cash to close can easily obtain it. A quick Internet search reveals a plethora of private lenders, joint ventures and small private consortia that are willing to make very short, "short-term no-doc" high-interest-rate loans at a 100% loan-to-value ratio, with 24-hour ap-

provals. Other individuals and groups are willing to provide transactional or "dough for a day" loans for fees that range from 12% to 15% of the loan.

Perpetrators can create the appearance of sufficient funds by paying a broker to locate the owner of a deposit account who is willing to add the crook's name to a third party's actual account (although the offender has no access to the funds) by contacting one of several companies that will, at no charge, provide a very official looking funds-commitment letter based only on the user's input of name, address and desired amount, or by going to Craigslist to identify vendors who can fabricate "novelty" documents - from identity and payroll records to investment and bank-account records and even "audited" profit-and-loss statements - to substantiate the buyer's financial wherewithal.

In this case, the best practices involve the following:

- Verify the source and seasoning of funds being used for the purchase;
- If the seller is a trust, obtain the trust documents and an affidavit listing the trustee(s)' name(s) and address(es) and the date the trust was created;
- If the buyer is an LLC, obtain an affidavit listing the name(s) and addresses of all owners, members, managers and partners; and
- Place participant names on watch and exclusionary lists as appropriate and upload the information to the automated fraud-prevention system to avoid being hit again.

The next step is to extract the illicit profit. The profit built in by the "flopped" sale price can be enhanced by adding "management" or "referral" fees, or excessive real estate commissions (more than 6% or 7% of the sales

price). Or, taking a page from the boom's "flipping" playbook, perpetrators can induce compliant, ignorant or complicit settlement agents to close the higher-priced sale to an end buyer so that funds from that transaction can be used to complete the short-sale purchase and allow the perpetrator to walk away with the difference.

To avoid alerting the end buyer's lender to the existence of and price paid for the short sale, the perpetrators may not record the deeds from that transaction. In those cases, the homeowner, who no longer actually owns the home, poses as the seller in the resale to the end buyer and delivers the proceeds to the perpetrator after the closing. The sale to the end buyer may also include fictitious charges against the seller's proceeds, excessive commissions and fees.

The best practices here involve the following:

- Check the purchase contract to see if there is an option clause or other expression of intent to resell the property;
- Make sure that the price on the contract matches the price on the HUD-1 (a mismatch may indicate the existence of an undisclosed transaction or a second set of closing documents);
- Check the HUD-1 settlement statement for unusual payouts and excessive fees; and
- Escalate files, as appropriate, if issues are found.

Mortgage fraud is alive and well, and is ripping us off. As an industry, we need to take steps to utilize all available strategies to remove opportunities for fraud. **SME**

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