Caught in the Fraud Trap

You don’t have to look far to find evidence that mortgage fraud is on the rise. Most telling is data from the Federal Bureau of Investigation (FBI) and the U.S. Treasury Department’s Financial Crimes Enforcement Network (FinCen) that tracks mortgage fraud through Suspicious Activity Reports (SARs) submitted by federally regulated lending institutions.

The number of SARs has risen dramatically in recent years, and the FBI estimates the reports represent a billion dollars in losses. While that number is significant, it underestimates fraud’s industry impact as it does not include losses from the non-federally regulated mortgage lending institutions that fund about half of all mortgages.

Telling Trends
In spring 2007, the Mortgage Asset Research Institute (MARI), issued its annual report highlighting fraud trends. MARI reported a 30-percent rise in the number of cases reported in 2006 over 2005. It’s interesting to note that Florida and California, two states where high price appreciation came to an end, are moving up in the state rankings of propensity for fraud.

The First American CoreLogic quarterly fraud index tracking 381 metropolitan statistical areas across the nation has been rising consistently over the past 12 quarters. The index, an indicator of fraud potential and delinquency risk, is 53 percent higher than it was three years ago. In addition to these industry-aggregated statistics on fraud trends, direct evidence shows a precipitous increase as real estate markets peaked in 2005. Lender-researched and identified fraud relative to total origination volumes shows this peak. While not all fraudulent loans will become nonperforming delinquencies, the approximate doubling of the overall rate is a pause for concern.

Scam Schemes on the Scene
Evidence suggests two particular fraud schemes are gaining popularity: builder bailouts and condo conversions. Neither fraudulent scheme is new, but both seem to be enjoying a popularity resurgence.

As the name suggests, a builder bailout is orchestrated by a builder to get out of a market where the builder is stuck with unsold homes that may otherwise sell at a loss. The scheme usually includes a loan officer or mortgage broker who identifies an investor to secure the loan or a “straw” buyer...
A Problem That’s Showing No Signs of Releasing Those in its Wake, **Mortgage Deceit** is a **Relentless** Cat-and-Mouse Game That’s **Ensnaring** Borrowers From State to State.
who agrees to let a third party use his or her name and credit information to obtain a loan. The mortgage broker, straw borrower, and investor typically come from outside the local market, so they are unfamiliar with local conditions, making it easier for builders to convince them of inflated prices. An appraiser may also be involved to provide inflated or profitablevaluations. At the beginning of the scheme, the builder may close a few non-arm's-length transactions with friends, relatives, etc., to inflate the perceived market values. Those sales inflate the comparables, allowing the builder to make a profit on properties they were otherwise unable to sell and to bail out of the poor market. As an added twist, the same borrower often “buys” multiple properties using falsified income to make it appear as if he or she has the monthly cash flow and capacity to pay on a primary residence, as well as investment properties. The loans ultimately fall into delinquency, and the targeted lenders experience a concentrated foreclosure event and high loss severity.

Builder bailouts are popular in areas with excess housing inventory, declining prices, or a new construction oversupply. These conditions, which often appear in combination, are the precipitating events that prevent the builder from selling under normal market conditions. Markets where these conditions exist include the Florida and Texas urban markets and some California markets where robust price growth has been replaced by declining values.

Evidence in recently identified builder bailout schemes indicates that there are a number of flags lenders can use to identify those deceitful practices. These include overstated incomes, the same borrower on multiple transactions, out-of-state borrowers and mortgage brokers, and inflated values, at least initially. Overstated incomes are not just appearing on stated-income documentation loans, which are now harder to secure because of industry-wide tightened credit policies, but as falsified full-documentation loans, too.

Rackets on the Rise

Condo conversions, legitimate and fraudulent, have gained popularity in the last few years as rising prices made it more profitable to sell than collect rent on multifamily complex units. In most cases, condo conversions are a legitimate way for owners to convert the future income stream from a multifamily property into a lump-sum cash-out. Fraudulent condo conversions, prices significantly inflated over the units’ true values create the problem. Similar to illegal flipping schemes, the owner conspires with an appraiser and/or a broker who states the condo is worth more than it is. They then convince a buyer to purchase the condo at the artificially inflated price. Because a condo conversion scheme falsely inflates the value of a large number of units in a small, concentrated area (the converting condo complex), the perpetrators only need to inflate the value of a few units to make the market. Once this is done, legitimate appraisals inadvertently support what seem to be reasonable market values. Lenders can incur severe losses, as the concentration of loans in the same complex also results in loss of risk-diversification benefits.

Fraudulent condo conversions are most common in markets with large multifamily stock where traditional condo conversions have been popular, such as the larger Mid-Atlantic, Northeast, and Midwestern
urban markets. In those markets, cooling or declining condo prices can create a greater incentive to perpetrate a fraudulent conversion. Condo conversions are most easily identified by checking the value reasonableness. Because values can begin to look reasonable as the conversion scheme matures, early detection is especially important. A scheme typically uses the same appraiser or mortgage broker to get it started, so it's also wise to look into the third parties involved, as well. As this is property flipping in a concentrated area and concerted manner, standard flip identification techniques may also help.

**Spotting the Fakes**

Identifying mortgage fraud is no easy task, and as fraud detection tools become increasingly sophisticated, criminals and their fraud schemes are also becoming well-bred. However, fraud technology tools exist to catch all types of fraud, including the builder bailouts and condo conversions described here.

Lenders can validate salaries by determining if the borrower's occupation, location, and experience (stated or in the documentation) seem reasonable. Checking the income for the provided occupation and location against comparative databases offers a good start, but many occupations have wide salary ranges. For example, many self-employed individuals have no occupational comparisons. Furthermore, what seems like an overstated income based on occupation, location, and experience, may simply be an individual performing at the top of their field. Consider, for example, the range of compensation for used car dealers. Not only do they vary greatly based on the dealer's ability, but the best and highest-earning used car dealer is also the most likely to stay in business if the used car market drops.

Identifying a loan for a fraud review using comparative income databases identifies the high fliers as well as the fraudulent transactions. To address this issue, we can analyze the borrower's historical debt patterns to determine reasonable salary levels. Assuming that most borrowers live up to their means and maintain their housing expenses at approximately the same proportional level, we can evaluate the historical trend in housing expenses and determine a likely current income. Combining the salary validation techniques with income expectations based on housing expense patterns allows lenders to differentiate high earnings from the falsified and inflated income. These income validation techniques are particularly effective at identifying soft fraud that does not necessarily lead to loan delinquency, as loan application misrepresentation and income inflation is a common way to perpetrate fraud.

Combining salary validation with identity tools that spot transaction participants who are serial investors not residing in transaction's real estate market or who own a large number of properties can provide the technology solution necessary to pinpoint and mitigate the recently popular fraud schemes. A thorough fraud detection and mitigation platform combines collateral risk tools and automated valuation models to help identify flipping and overvaluation conditions with income and identity validation tools. Given the recent rise in reported fraud and current market conditions, combining these tools to fight fraud is more important than ever before to halt this parade of deception.