MORTGAGE FRAUD

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23rd November, 2007

A recent Galaxy survey indicated that as many as 2.7 million Australian deliberately falsified details on their loan applications by exaggerating or under-estimating figures. What is prompting this growing culture amongst borrowers?

There are numerous reasons for proliferation of mortgage fraud. They include:

1. Desperation – people are finding that the property market is priced at the outer limits of people's financial capabilities but realise that unless they jump on the property ladder now they will be left behind for there is a perception that the prices will continue to exceed salaries and salary increases;
2. Social decay of principles – these days, a large number of people believe that falsifying applications is part of the 'norm' and not a crime. They are wrong but this mistaken belief is becoming more prevalent in our Australian culture;
3. Lenient 'white collar' crime sentences – there is a perception that court sentences and penalties relating to 'white collar' (non violent) crimes are lenient. Therefore, the ramifications of getting caught is minor and 'worth having a crack at';
4. "I won't get caught" – a growing number of people believe that the police and courts are understaffed and do not have the resources to catch people or that the court process is unduly expensive or time-consuming and that a lender will make a deal (take a loss) so they can get on with lending to other people;
5. Anonymity – the current employment market has a high turnover component and there are more transitory customers and contacts. Such elements facilitate fraud, for "in the old days", an employee would have been with an organisation for a long time, become more familiar with lenders and an employer's system which would identify fraud. However, as people jump from job to job they can lose discipline to learn and follow an employer's fraud mitigation guidelines. Furthermore, the clients "in the old days" did not travel much and were normally born and raised in the community so they were known by the lender and less likely to betray such trust, get away with fraud and up and leave.
6. Technology - sophisticated technology has increased the ease of perpetrating fraud. Criminals now have easier access to the information and technologies needed to commit mortgage fraud. Furthermore, systems allow the lender to rely on a system instead of relying on "their gut instincts". Don't get me wrong, it is good to have systems but do not blindly rely on same.
7. Death by Paperwork - According to some insurers, a large percentage of cases involving fraud relate to mortgage application documentation. It is common knowledge to anyone who has ever applied for a mortgage that there is an enormous amount of paperwork. The amount of supporting documentation required can be far greater than that needed for a personal loan. Due to the amount of information required, many people assume that overestimating or underestimating the facts is acceptable. The problem is that such deception, whether large or small, is fraud and thus illegal.
8. Speed – The need for volume and high loan velocity creates a quicker and more profitable process but also leads to glancing over matters and checks which then leads to mistakes and losses. The Australian commercial environment has tried, unsuccessfully, to achieve the "Impossible Triangle": (i) Faster; (ii) Cheaper; and (iii) Better. However, you can usually only have two of the three points to the detriment of the third.
9. Data on incidents of Fraud – the industry is starting to compile and more accurately collate data on incidents of fraud.

How much of a threat to the lending industry is soft fraud from borrowers?

The risk is substantial. Most funders factor in a percentage of their deals to fall foul of fraud. It is not as if reputable lenders have been caught unaware by the increased trend of fraud.

Monitoring the levels of fraud and investing in investigations, training and fraud mitigation systems are some of a lender's and broker's greatest tools in the fight against fraud. If any of these tools is neglected then the lender's and broker's return on investment will reduce which may lead to less money to spend on the tools and thus perpetuating the problem and loss of return (creating a 'vicious cycle').

A social ramification of the ‘white lie’ fraud is that a borrower will overstretch themselves. With reputable lenders and brokers, they will tell a borrower when they are overstretching themselves and (a) recommend not taking a loan or (b) recommend a different, more suitable, product. If the information is false then the lender and broker will not have the opportunity to assist the borrower.

Originators that neglect or downplay quality control do so at their own peril. The consequences of the discovery of mortgage fraud in a portfolio can have a devastating affect on a licensee, registrant or broker organisation, even if the company is a victim of fraud.

Some of the common consequences of fraud are: sudden withdrawal of investor support; loss of servicing portfolios following unfavourable audit findings; unanticipated demands of the principal lender to repurchase mortgages; direct write offs; sudden loss of top personnel; and ultimately, suspension or loss of licenses.

How can mortgage lenders identify embellishments in applications?

The industry can help protect itself and the broader public by creating a climate and culture that places a premium on quality control. Mortgage companies with effective quality should have same reflected in their policies and procedures, compensation schemes and marketing efforts.

Ideally, having systems and training in place which assist a lender/broker identify:

(a) fraud;

(b) the reasons behind the fraud; and

(c) training in recognising the common types of fraud (examples below)

will greatly minimise fraud occurring.

The following non-exhaustive steps should assist a fraud prevention program:

Pre-Funding Checks

(1) Verbal verification of employment income and employer, including independent verification of the employer’s phone number. Also, performing the verification as close to loan settlement as possible will help prevent fraud from a scam involving temporary phone lines set up specifically to verify the borrower employment. This should also extend to income verifications.

(2) Carrying out independent credit report checks, especially where a residential mortgage credit report was provided by another party. Credit reports should be reviewed all the way down to the last line. One red flag is multiple enquiries that were recently made indicating a possible consolidation loan that is not yet showing on the bureau. Checking with the listed financiers to check the current status of the enquiry.

(3) Ensuring loan documentation received are the originals and not facsimile or photocopy records which may have been altered.

(4) For self employed, signed Taxation Returns. Requiring this form on the front end will discourage some fraudulent borrowers from completing the transaction.

(5) Proper borrower/guarantor identification obtaining photo ID, driver’s license, passports etc…

(6) Verify the seller on the contract is the owner of record on the preliminary title report. This requires teaching employees how to read title searches. Other title red flags include delinquent property taxes.

(7) Specify in settlement instructions to the lender’s solicitors if source of funds should be verified.

(8) Choose referrers and employees wisely. Deal only with parties who are properly vetted by you as to background character and integrity. What is their track record? Do they have substance? Choose parties who have real regard for “reputation risk” and sustaining loss when things go wrong.

Post-Funding Checks

(1) Having an internal computerised fraud report and cross-checking system which regularly reviews all delinquent files for systematic relationships between a particular employee, broker, real estate agent, valuer and staff loan underwriting… ask more questions.

(2) Check any files that are immediately put into substantial credit following loan settlement.

(3) Not used in Australia, but perhaps moving forward, lenders will be forced to consider the US model of requiring brokers to “buyback” bad loans. This is extreme but may force “cowboy brokers” to shape-up or ship-out. Australia has a quasi version of this with clawback of commission provisions.

Regulation may lead to Fraud Mitigation

Reform of consumer credit legislation at a national level and regulation of providers of finance will provide consistency of service, systems and integrity which in turn will mitigate fraud.

Additionally the following may help:

- Support from all lenders and industry participants for a single national regulator for all secured loans; and
- The need for the broking industry to be nationally regulated and formally licensed, with appropriate requirements for capital, adequate compensatory arrangements and standards of education.

Proper file management practice and procedure is important for any professional.

This will ensure a paper trail, which can be followed to find what passed between the parties if problems arise. These files can contain instructions and requests for information in writing, notes of all conversations between the parties and important dates to ensure they are not forgotten. Any e-mails between the parties should be printed and kept in a matter file. Never hesitate to ask the other party to confirm something in writing (particularly variations). If there is any dispute at a later time you will have a written record of their intentions.

In cases where fraudulent applications are exposed who is liable for any losses – lender/ mortgage manager/ borrower?

(a) Fraud affected by the borrower: borrower is liable for the losses incurred by the lender and broker.

(b) Fraud affected by the broker: broker is liable for the losses incurred by the lender.

(c) Where a broker has failed to follow the lender’s procedure, which would have identified the fraud, then the broker is liable for the losses to the lender;

(d) Where there is no procedure but it is common practice in the industry and the broker did not follow same, which would have exposed the fraud, then the broker would be liable for the losses to the lender;

(e) A lender can be sued by a broker if the damages incurred by a broker were the result of inadequate systems, training and guidelines to identify fraudulent acts if the lender’s systems, training and guidelines are not being followed by the lender or are below the accepted industry standards.

Regardless of whether a broker is liable, the relationship between the broker and lender may be irreparably damaged and lead to revocation of accreditations. This will lead to reputation and financial issues.

Although it is not a ‘front-end’ way of avoiding risk in the first place, all businesses are advised to carry appropriate professional indemnity insurance and to have an asset protection strategy. This will at least minimise the impact of any successful claim.

Types of Mortgage Fraud

The falsifying of information on mortgage loan applications may be small or large. Some cases of great falsification have been reported. Often severe cases are part of a much larger problem, usually involving more than one person. These incidents usually do not occur at the applicant level. Mortgage fraud is generally committed at two distinct levels.

1. Applicant Level – The person applying for the mortgage initiates and commits the fraud.

Some fraud is perpetrated through falsified information that the applicant alters. The most common kind of falsified information consists of changing facts on a tax return, income verification or purchase price of the security.

2. Lending Level – The fraud at this level is committed by persons directly involved in the mortgage lending or origination (broking) process.

The following are some of the commonly identified fraudulent practices currently in use:

> (a) Fraudulent documents – Technology has permitted the production and submission of high quality authentic looking but fraudulent documents such as pay slips, letters of income & employment, tax returns, financial statements, verification of deposits, employment letters and credit reports.
>
> (b) Targeting of Applicants – The identification and recruitment of applicants who feel desperate enough to go along with the fraud.
>
> (c) Use of Insiders – Employees are pressured to participate in the fraud by threat of job loss or the withholding of compensation.
>
> (d) Straw Buyers – The production of fraudulent paper to obtain loans in excess of what is supportable by the underlying property and the use of "straw buyers" of "ghost loans".

Deliberate participation by the mortgage professional in any fraudulent scheme or gross negligence which facilitates such schemes, should not be tolerated. In such instances, lenders and regulators should not hesitate to use the full force of the law, including criminal prosecution.

Documents Commonly Used in Mortgage Fraud

Due to the large amount of documentation involved with securing a mortgage, there are numerous areas that are open to fraud. The top five documents that most commonly contain falsified information are:

- *Application* – The application may contain false information about income, debt, employment, and other items.
- *Tax Returns* – Information may be altered to leave the impression of higher income.
- *Employment Verification* – Changes may be made to employment dates, hourly or salaried earnings, job position, or other work-related information.
- *Bank Deposit Information* – Actions taken mostly to inflate an individual's cash on hand. Some people will make large cash deposits, from an outside source such as a credit card, friend, or relative in order to increase the current balance, which leaves the impression of having more cash on hand than is actually true.
- *Security Valuation* – This fraud can be committed by the borrower, the Valuer, or both. The borrower could alter the valuation on the actual document, the Valuer could inflate the home's value, or the borrower could pay the Valuer to inflate the home's current value. The result of this fraud has most recently been felt around the country as Valuers Professional Indemnity Insurers are now refusing to conduct valuations for many parties on the grounds that those parties constitute a high risk for claim to Valuers because of their poor lending and/or loan management practices. Regrettably, some lenders got caught up in this inadvertently with the "two-tiered" markets of Queensland in the last decade with over inflated purchase price which formed the sole basis of the lending assessment.

The above are some examples of fraud. There are many other types of fraud within the mortgage industry.

CONCLUSION

Regardless of national regulation, you should at least have the above steps, systems, training and supervision of employees, brokers and clients in place. Your best line of defence is to ask a lot of questions.

In a perfect world we would do a thousand checks, have forever to check out a deal and know the borrower personally and conduct a due diligence of their finances. This is not realistic or commercial. The main question is "When have I done enough?" This is a difficult question to definitely answer but if you adopt the above steps it will greatly minimise your exposure to fraud and provide you a commercial and practical compromise. If in doubt, talk with your lender or their lawyer. Write down what they say, confirm it in writing and follow it to the letter.

As this Article has highlighted, there are many traps for business in relation to mortgage fraud. Be mindful of the points raised and if in doubt, seek legal advice.

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