



## *Commercial Spotlight*

### **Mortgage Lending Risk – A Proactive Approach to Reducing Fraud Risk Exposure**

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Mortgage fraud not only contributed to the overall downturn in the U.S. economy, it also has been exacerbated by it. The Federal Bureau of Investigation's (FBI) most recent Mortgage Fraud Report notes that the combined effects of higher unemployment, a spike in foreclosures, contracting financial markets, and diminishing credit both "uncovered and fueled a rampant mortgage fraud climate."<sup>1</sup>

The pressure on financial institutions is certain to increase in coming months. One independent study predicts seven million properties are destined for foreclosure in the coming year,<sup>2</sup> and a November 2009 study by the Mortgage Bankers Association found that more than 14 percent of borrowers were in trouble on their mortgages during the third quarter of the year. Significantly, their survey suggests that the foreclosure rate is likely not to peak until late in 2010.<sup>3</sup> The financial and administrative challenges posed by this wave of foreclosures will add to the stress on banks' already-strained resources, and will further limit their ability to respond promptly to cases of suspected fraud.

Despite increased attention from financial institutions, investors, insurers, and regulators in recent months, a significant amount of fraud risk remains hidden within the mortgage portfolios of all types of institutions, not just those that were active in subprime lending. Prudent managers should take steps now to identify and address mortgage fraud proactively, rather than waiting for regulatory scrutiny to force them to act.

### **Mortgage Fraud Facts – Size and Scope of the Problem**

Often misidentified as a function of the "subprime crisis," the problem of mortgage fraud actually extends far beyond subprime lending alone. Although there is no central repository for mortgage fraud complaints, the FBI notes that virtually all law enforcement and industry statistics indicated an upswing in mortgage fraud activity during 2008 and early 2009.

One key indicator is the number of Suspicious Activity Reports (SARs) submitted to the Financial Crimes Enforcement Network (FinCEN). There were 63,713 mortgage fraud related SARs filed with FinCEN in fiscal year 2008, a 36 percent increase over fiscal year 2007. The financial impact of these incidents shows an even sharper spike – an 83.4 percent jump over 2007, to a total of more than \$1.4 billion in losses.<sup>4</sup>

Preliminary statistics indicate total SAR filings in fiscal year 2009 will exceed 70,000, and SAR losses reported in the first six months of fiscal year 2009 exceeded the same period in fiscal year 2008 by an additional \$208 million.<sup>5</sup>

### **Identifying and Understanding Types of Fraud**

The dozens of various mortgage fraud schemes generally are organized into two broad categories. The first, "fraud for property," generally involves misrepresentations by the loan applicant and affects only a single loan. Applicants typically embellish income or conceal debt and, despite their original intention to repay the loan, run into trouble due to loss of income or a dramatic drop in the property's value.

The second category, "fraud-for-profit" or "insider fraud," often involves multiple loans and more elaborate schemes, and poses a far greater overall risk to lending institutions. The FBI estimates 80 percent of all reported fraud losses involve collaboration or collusion by industry insiders rather than misrepresentation by an applicant acting alone.<sup>6</sup>

Prominent fraud-for-profit schemes include builder bail-outs, short sales, foreclosure rescue and credit enhancement schemes, illegal loan modifications, and illegal property flipping – to name just a few. To carry these out, perpetrators employ techniques ranging from straw buyers and identity theft to shell companies, fraudulent or forged loan documents, and inflated appraisals.

## **Categorizing and Assessing Institutional Risk**

The securitizing and reselling of mortgage-backed assets can complicate the challenge of assessing fraud risk. As loans from individual institutions are bundled and sold to larger investors, the size and nature of the risk is often hidden – that is, until the investors' recourse notices start arriving at the originating institution.

The most obvious risk in such cases is financial, in particular the risk that the originating institution will be required to buy back nonperforming assets, or that private mortgage insurers will refuse to cover the institution's exposure on loans with minimal down payments.

Mortgage fraud also exposes the loan originator to increased regulatory risk. Failing to file a SAR when required can lead to penalties and enforcement actions. In addition, the cost of compliance with fraud reporting requirements can be significant, especially when a distressed institution is acquired by a healthy institution as part of a Federal Deposit Insurance Corporation-supported rescue.

Mortgage fraud exposes the institution to other types of risk, such as loss of reputation and other competitive disadvantages. This combination of financial, regulatory, reputational, and competitive risks makes it imperative that financial institutions thoroughly and accurately assess their exposure to potential mortgage fraud.

### **A Proactive, Risk-Based Approach**

Early identification of mortgage fraud risk is critical, not only for institutions or investors that purchase securitized loan portfolios, but for the originating institutions as well. Many types of fraud are readily identifiable before or immediately after closing. Unfortunately, even in large institutions that devote significant resources to self-monitoring and quality control, it is common to find critical reviews are many months overdue.

Such delays allow additional instances of fraud to occur and make it more costly to mitigate the effects of fraud hidden in the portfolio. When fraud is uncovered by regulators, the required corrective actions are almost always more costly and impose a greater administrative burden than they would have if the institution had identified the problem on its own.

Because of these escalating costs, quick response to recourse notifications is critical – and will become even more important as secondary investors scrutinize their portfolios more closely for noncomplying loans. In response, the originating institution should take a risk-based, targeted approach toward sampling the portfolio and be alert to trends or issues related to a specific control or lack of a control.

Some common red flags to look for to help identify fraud schemes include:

- Obvious problems in individual loans such as misstated or fraudulent income;
- Weak documentation or verification of income, employment, credit history, and other factors;
- Relying on peer reviews of documentation, rather than supervisory controls;
- Extensive reliance on third-party mortgage brokers; and
- Loans made during periods of extremely high volume, when the urge to take shortcuts was high.

Any of these – or dozens of other signs of trouble – should trigger a review of similar or related loans to identify patterns or systemic weaknesses.

### **A Comprehensive, Systematic Method**

In addition to being timely and proactive, an institution's mortgage fraud mitigation program should also be comprehensive and systematic. Typically, such a program will encompass at least five phases:

1. **Risk assessment.** Various fraud risk factors are identified and weighted against the institution's lines of business to pinpoint where greater control is most needed.
2. **Prioritized roadmap.** Gaps are organized and prioritized into initiatives that can be measured for return on investment. This becomes a communications tool for management, the board, and regulators to use in creating an environment of transparency, and to demonstrate that the institution understands its risks and is proactively working to make improvements.

3. **Implementation.** The institution designs, implements and optimizes internal controls to further mitigate risks going forward. These efforts drive efficiencies into the process, while enabling the institution to respond quickly to threats and incidents, and improve detection, reporting, and recovery of assets.
4. **Monitoring.** The internal audit function is educated and actively engaged in the effort, including a comprehensive annual review of fraud controls.
5. **Continuous improvement.** Ongoing monitoring and enhancement ensure that the right investments are made in the future to further minimize risk.

Significant mortgage fraud risk can exist in all types of institutions, not just those that were active in subprime lending. Moreover, the risk to the originating lender does not end when the loans are securitized and sold on the secondary market.

To protect all stakeholders – including investors, employees, customers, and the broader community – bank executives should take active steps to identify, address, and ultimately reduce their institutions' exposure to mortgage fraud risk in both their current portfolios and their future lending activity.

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<sup>1</sup> Federal Bureau of Investigation, "2008 Mortgage Fraud Report Year in Review," page 2, [www.fbi.gov/publications/fraud/mortgage\\_fraud08.htm](http://www.fbi.gov/publications/fraud/mortgage_fraud08.htm).

<sup>2</sup> Stephanie Armour, "Another wave of foreclosures looms," *USA Today*, Nov. 19, 2009, [www.usatoday.com/money/economy/housing/2009-11-19-shadow19\\_ST\\_N.htm?loc=interstitialskip](http://www.usatoday.com/money/economy/housing/2009-11-19-shadow19_ST_N.htm?loc=interstitialskip)

<sup>3</sup> Renae Merle, "Problem mortgages hit new high at 14 percent," *Washington Post*, Nov. 20, 2009, [www.washingtonpost.com/wp-dyn/content/article/2009/11/19/AR2009111903885\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/11/19/AR2009111903885_pf.html)

<sup>4</sup> Federal Bureau of Investigation, op. cit, page 3

<sup>5</sup> *ibid.*

<sup>6</sup> Federal Bureau of Investigation, "Financial Crimes Report to the Public Fiscal Year 2007," page 14, [www.fbi.gov/publications/financial/fcs\\_report2007/financial\\_crime\\_2007.htm](http://www.fbi.gov/publications/financial/fcs_report2007/financial_crime_2007.htm).