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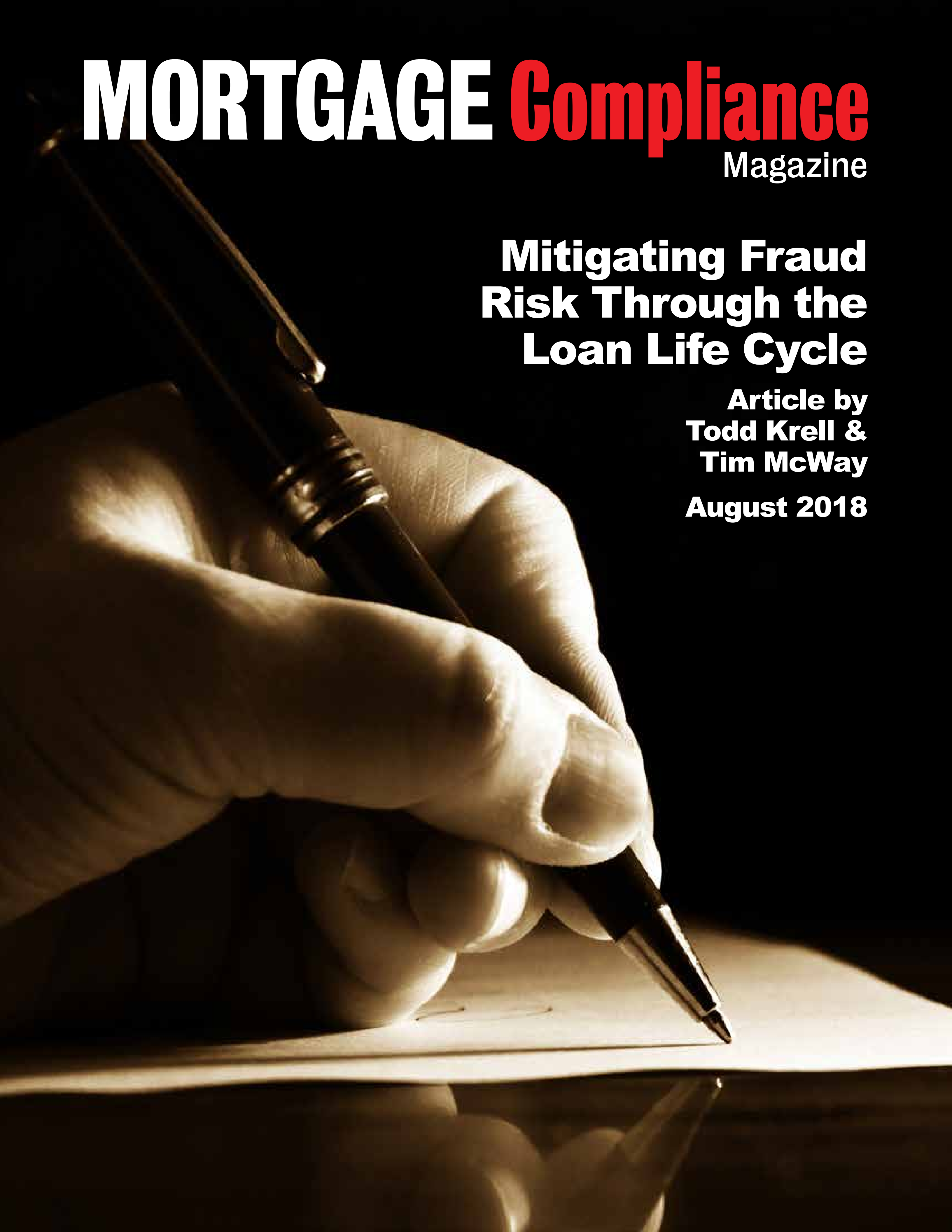

Mitigating Fraud Risk Through the Loan Life Cycle

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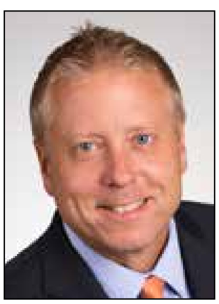
MITIGATING FRAUD RISK Through the Loan Life Cycle

BY TODD KRELL & TIM McWAY



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Industry data indicates that mortgage fraud is once again on the rise after reaching historic lows between 2014 and 2016. The CoreLogic National Mortgage Application Fraud Risk Index has increased each of the last six quarters, and for the period 2016-2017, CoreLogic's data indicates fraud is up 17 percent. Fannie Mae data, in its Mortgage Fraud Trends, indicates that the level of fraud tips has been increasing and that there has been an uptick in lender self-reporting of fraud. The increased levels of fraud are occurring despite the industry's effort after the financial crisis to self-regulate and the regulatory changes put in place. A fraud prevention program that encompasses the entire loan life cycle can help mortgage lenders mitigate fraud risk.

WHAT IS BEHIND THE INCREASE IN FRAUD?

Many believe there are several factors contributing to the recent rise in misrepresentation and fraud. The economy shows signs of stability and unemployment is at new lows; however, after record levels of refinance transactions over the last several years, we are seeing a rising rate environment with fewer refinancing opportunities. CoreLogic states that the percentage of purchase applications rose to 62 percent of all applications taken in Q1 2018. Historic data has shown that purchase transactions have higher fraud risk than refinance transactions. A rising rate environment also leads to more competition among mortgage bankers, brokers, and institutional banks. With fewer potential borrowers in the market, some originators may go to greater lengths to make new loans. As the market adjusts to this new environment, it is imperative for lenders to take time to re-evaluate their processes and procedures relating to the loan cycle from origination through servicing.

Although, mortgage fraud remains low compared to the pre-financial crisis, there are more areas in the loan life cycle in which perpetrators are manipulating the integrity of the mortgage process. What we consider to be mortgage fraud and who we consider to be victims are also changing. In the past, the investor or lender was the victim in most types of mortgage fraud for profit or fraud for housing schemes. However, in today's digital world, the borrower, closer, or servicer is just as likely to be the victim.

A FRAUD PREVENTION CULTURE BEGINS AT APPLICATION

The potential for fraud still starts at application; however, it does not end when the loan is closed, sold, and serviced. Therefore, a lender's fraud prevention program should also start at application and never end if the lender services loans. Mortgage lenders considered to be the leaders in fraud prevention do not simply have a robust fraud prevention program, they have a strong fraud prevention culture. This starts from the top down, with management embracing fraud prevention by creating a culture that includes open communication, training, tools, and awareness. This is not an easy task for management given the cost of originating a mortgage loan continues to rise; however, it can be invaluable as it will often lead to money saved, as well as investor and customer loyalty.

Therefore, lenders who strive to incorporate a fraud prevention culture should implement a policy that empowers the loan officer, along with the real estate agent, if applicable, to have an open dialogue at application with the borrower regarding mortgage fraud. This conversation should include what steps the borrower can take to ensure they are not a victim but also a high-level explanation of the steps the lender will be taking during the process to ensure it is also not a victim. This communication can often lead to a borrower realizing that certain statements, omissions, or acts, although considered minor to them, would be considered mortgage fraud by most definitions. These include statements about liabilities, occupancy, and identity. Explaining to the borrower what is and is not considered mortgage fraud and what verifications and re-verifications will be performed can mitigate a lot of risk early in the process.

PROCESSING, UNDERWRITING, AND PRE-FUNDING QUALITY ASSURANCE

The processing, underwriting, and pre-funding quality assurance stages of the loan life cycle remain the front lines of preventing the most common fraud schemes. Management can display its commitment to creating a fraud prevention culture by providing the operations staff with the training, procedures, tools, and authority needed to be successful. Monthly or quarterly training for the entire operations staff not only results in increased awareness of possible fraudulent activity but also reinforces management's view on fraud prevention to the staff.

STRONG PROCEDURES, TOOLS, AND AUTHORITY

One thing that has not changed over the last two decades is that an operations staff with the proper procedures and training, supplemented with robust tools and authority, will have a higher identification and prevention rate. Strong procedures would include: empowering the processor to reconfirm data with the borrower verbally; providing underwriters with a robust red flags checklist created from investor and FBI recommendations, quality control findings, and fraud reports, including employment re-verifications in the pre-funding quality assurance process; and, increased targeted pre-funding sample sizes. The underwriter and pre-funding quality assurance analyst should be given the authority to increase the scope of the review at any time during the loan life cycle. Many lenders submit suspicious applications to third-party vendors for a deeper dive fraud review. Although this adds additional cost and time to the application process, it can save thousands of dollars by putting a stop to closing an unsalable loan. The goal of the processing, underwriting, and pre-funding quality assurance departments should be to identify misrepresentation or fraud regarding the borrower's employment and income or the occupancy of the transaction. These fraud ▹

areas, all prevalent before the financial crisis, are making a comeback in several forms such as fictitious employers in certain areas, as made aware by Fannie Mae in May 2018, and verbal verifications misrepresentations, typically not identified until post-closing quality control efforts. Also, borrowers are still misrepresenting the occupancy of the property to take advantage of lower rates, lower down payment requirements, and higher LTV ratios.

THE INCREASE IN WIRE FRAUD

In today's mortgage lending, fraud prevention does not stop after the loan has been approved. Many believe that in today's digital world there is an increased risk of fraud at the closing and servicing stages of the loan life cycle especially when you consider that the borrower and title company are now potential victims. Potential fraud risk at the closing and servicing stages are wire fraud, loan modification fraud, and foreclosure scams. Wire fraud is prevalent in all types of industries; however, mortgage banking is especially vulnerable as millions of dollars are sent via wire transfers daily. Each transfer creates an opportunity for a fraudster to take advantage of a borrower, lender, or title company.

The most common type of wire fraud affecting the mortgage industry stems from transfer instructions being altered, which causes funds to be delivered to the wrong account. This is typically accomplished by an email account being compromised by the fraudster, which is referred to by the FBI as a business email compromise or BEC. In this scenario, the borrower receives an email containing updated wire instructions which appears to have been sent by the lender or title agent. However, the fraudulent email is really instructing the borrower to wire funds to an account in the name of the fraudster. Once received, these funds are typically transferred overseas within 24 hours, making recovery of the funds virtually impossible.

Early education of the borrower by the loan officer or processor is one way to protect your customer; however, the use of dual authentication which includes a verbal confirmation of the instructions with the borrower is considered the best prevention. This includes the wire instructions containing a phone number for the borrower to contact the lender or title agent to verbally verify the instructions, account number, and amounts.

Loan modification and foreclosure rescue scams are typically carried out by perpetrators contacting borrowers, offering assistance with securing a modification or foreclosure for the borrower from the servicer. Many perpetrators of this scheme claim they are providing "legal" representation or work in conjunction with the government. A large fee is collected in advance, which is illegal in some states, and the company does nothing to help the borrower. These types of schemes should be discussed with customers at closing and even by the loan officer as early as the application stage.

CONCLUSION

As the economy and employment continue to move forward in a positive direction, and the borrowing rates increase, it is imperative for lenders not to get complacent with the measures they have put in place over the last few years. There will never be a time when fraud completely disappears from the loan process, and those instigating the theft will always be working to stay a step ahead of the risk management controls currently set up as barriers. Recurring employee training and the use of mortgage industry partners and technology must become part of the continuum from origination through servicing to combat abuses to the consumer and the lender, which can ultimately drive up costs for everyone.

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