



# The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties

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# **The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties**

## **INTRODUCTION**

The following interagency white paper focuses on ways that financial regulators and the industry can detect, investigate, and deter third party mortgage fraud. Since insider loan fraud was addressed in a separate white paper dated April 2003<sup>1</sup>, this paper does not specifically discuss mortgage fraud involving only insiders.

The first of four sections provides some background information on third party residential real estate (RE) mortgage fraud and discusses the primary motives for this type of fraud. The second section includes a description of some of the key third parties involved in residential mortgage lending and provides examples of the basic loan origination and acquisition processes. It also includes a summary of the October 2003 Interagency Appraisal and Evaluation Function statement the full text of which is in Appendix - G. The third section details some examples of the more common third party mortgage fraud schemes and describes a number of red flags to help identify them. The fourth section provides examiners with some helpful tips when considering and/or conducting an investigation. Additionally, it provides steps that financial institutions (FI) can take to mitigate the risk of third party mortgage fraud. Lastly, the paper includes appendices that contain additional guidance and references regarding mortgage loan fraud. Many of the terms found throughout this paper are specific to the mortgage industry and are defined in Appendix A - Glossary.

**This paper is not intended to override or replace current examination policies and practices. Examiners should only use the procedures and practices discussed in this paper in consultation with their supervisors when they discover warning signs that warrant expanded scope.**

## **BACKGROUND**

Third party residential RE mortgage fraud poses a growing risk to the financial entities that finance the \$3 trillion annual residential RE market (Mortgage Bankers Association, 2003) in the

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<sup>1</sup> "The Detection, Investigation, and Prevention of Insider Loan Fraud: A White Paper" is available on line at [http://www.ffiec.gov/pdf/ilf050703\\_guidance.pdf](http://www.ffiec.gov/pdf/ilf050703_guidance.pdf).

United States. For the purposes of this discussion, the term "third party" refers to the parties necessary to execute a residential mortgage other than an FI and a legitimate borrower. Examples of third parties include mortgage brokers, correspondents, RE agents, RE appraisers, and settlement agents. In this paper, mortgage fraud refers to a material misrepresentation made by a third party in the mortgage loan document(s) or orally in order to induce the lender to make a loan he might not otherwise make. The resulting product may also be inconsistent with investor/product guidelines. Although there is no comprehensive study detailing the economic cost of mortgage fraud, estimates by experts and industry professionals indicate that it is substantial and growing. Mortgage loan fraud is expanding because it can often be very lucrative and relatively easy to perpetrate, particularly in geographic areas experiencing rapid appreciation. Given the record volume of the past few years, many lenders have been less thorough in their pre-funding and quality control (QC) reviews and other efforts. This lack of controls and due diligence can contribute to increased occurrences of fraud.

Industry studies indicate that a significant portion of the loss associated with residential RE loans can be attributed to fraud. Industry experts estimate that up to 10% of all residential loan applications, representing several hundred billion dollars of the annual U.S. residential RE market, have some form of material misrepresentation, both inadvertent and malicious. An in-depth review by The Prieston Group of Santa Rosa, California of early payment defaults, an indicator of problem loans, revealed that 45-50% of these loans have some form of misrepresentation. Additionally, this study showed that approximately 25% of all foreclosed loans have at least some element of misrepresentation, and losses on fraudulent loans equate to approximately 37% of the loan balance.

Since the variety of fraudulent mortgage schemes is limited only by the imagination and resourcefulness of the perpetrators, third party residential mortgage fraud is difficult to detect until losses have occurred. The ability to perpetrate a fraud has been made much easier through technological and computer advancements like imaging. Mortgage fraud can represent a significant risk to the safety and soundness of an FI and increase a variety of other risks within the FI such as financial, reputational, legal, operational, and strategic. The financial impact from these elevated risks can vary greatly based upon the complexity and pervasiveness of the fraud and the FI's level of participation in the residential mortgage market. For example, an FI's risk in a simple third party fraud may be limited to losses associated with a single loan or, if the fraud involves a complicated and pervasive fraud scheme, the exposure may extend beyond the balance sheet to include the risk associated with

thousands of loans that an FI may be required to repurchase from the secondary market.

## **MOTIVES**

While greed is the overall motivator in any fraud scenario, the mortgage industry has identified three specific motives for mortgage fraud. These motives, which are described below, are fraud for housing, fraud for profit, and fraud for other criminal purposes. Inherent to each of these is the potential that some of the individuals involved are unsuspecting, unknowing, or unaware that they are participating in a fraud scheme and that their actions may be illegal.

Fraud for housing, which is exactly what the term implies, is the first motive. It is a misrepresentation and/or concealment made by a borrower or other party in order to qualify for a mortgage loan. The applicant may understate expenses, disguise the source of the down payment, alter or falsify a tax return, or misrepresent employment in order to qualify for the loan. Generally, the borrower intends to make the loan payments and does not have a profit motive. A third party broker, appraiser, developer, builder, financial advisor, or other participant attempting to help the new homebuyer, may assist in the fraud by inflating a value or by omitting/understating expenses. While these frauds may seem harmless, investors such as FHLMC (Freddie Mac), FNMA (Fannie Mae), or GNMA (Ginnie Mae) may discover the fraud and demand that the originating lender repurchase the unpaid principal balance of the loan or compensate the investor for liquidation costs on foreclosed properties. Once detected, a simple misrepresentation can have large consequences for the originator, seller, or investor.

The second motive, fraud for profit, is a major concern for the mortgage lending industry. It often results in larger losses per transaction and usually involves multiple transactions. The schemes are frequently well planned and organized. There may also be intent to default on the loan when the profit from the scheme has been realized. Multiple loans and people may be involved and participants, who are often paid for their involvement, do not necessarily have knowledge of the whole scheme.

Fraud for profit can take many forms including, but not limited to:

- Receipt of an undisclosed or unusually high commission or fee,
- Representation of investment property as owner-occupied since FIs usually offer more favorable terms on owner-occupied RE,

- Sale of an otherwise unsalable piece of property by concealing undesirable traits, such as environmental contamination, easements, building restrictions, etc.,
- Attainment of a new loan to redeem a property from foreclosure to relieve a burdensome debt,
- Rapid buildup of a RE portfolio with an inflated value to perpetrate a land flip scheme,
- Mortgage of rental RE with the intention of collecting rents and not making payments to the lender, retaining funds for personal use,
- The advance of loan approvals for customers to benefit from the commission payments, and/or
- Misrepresentation of personal identity, i.e., use of illegally acquired social security numbers, to illegally obtain a loan, or to sell/take cash out of equity on a property with no intention of repaying the debt.

The third motive, which involves additional criminal purposes beyond fraud, is becoming more of a concern for law enforcement and FIs. This involves taking the profit motive one step further by applying the illegally obtained funds or assets to other crimes, such as:

- Money laundering through purchase of RE, most likely with cash, at inflated prices,
- Terrorist activities such as the purchase of terrorist safe houses and,
- Other illegal activities like prostitution, drug sales or use, counterfeiting, smuggling, false document production and resale, auto chop shops, etc.

## **PARTICIPANTS**

It is important to be aware of the different participants and transaction flows to understand the fraud schemes described in this paper. This section provides background information on various participants and their roles in typical mortgage transactions.

### **Participants**

Common participants in a mortgage transaction include, but are not limited to:

- Buyer - a person acquiring the property,
- Seller - a person desiring to convert RE to cash or another type of asset,
- Real Estate Agent - an individual or firm that receives a commission for representing the buyer or seller,

- Originator - a person or entity, such as a loan officer, broker, or correspondent, who assists a borrower with the loan application,
- Processor - an individual who orders and/or prepares items which will be included in the loan package,
- Appraiser - a person who prepares a written valuation of the property,
- Underwriter - an individual who reviews the loan package and makes the credit decision,
- Warehouse Lender - a short term lender for mortgage bankers that provides interim financing using the note as collateral until the mortgage is sold to a permanent investor, and
- Closing/Settlement Agent - a person who oversees the consummation of a mortgage transaction at which the note and other legal documents are signed and the loan proceeds are disbursed.

Refer to Appendix A - Glossary for additional and expanded definitions for participants and other terms used throughout this paper.

### **BASIC MORTGAGE TRANSACTIONS**

The following transactions are generally the same whether the purpose of the loan is to purchase a property, refinance an existing loan, or obtain a loan against a property that is unencumbered.

**Retail** - Initiated by an individual through an FI loan officer, this is the most basic transaction with the fewest third parties. All parties can be FI employees, but the appraiser and closing agent are frequently third parties. Usually, the application package, which includes financial information, a credit report, an appraisal or automated valuation model (AVM), title information, and various other credit related documents, is completed and forwarded to an underwriter for a credit decision. The FI then releases funds to a closing agent, who disburses funds to the various parties. The completed package is returned to the FI, reviewed for quality and accuracy, and is either held on the FI's books or sold into the secondary market to Fannie Mae, Freddie Mac, Ginnie Mae or alternative investor. Retail origination only includes loans closed in the FI's name.

**Broker Origination** - A broker originated loan is similar to the retail mortgage transaction except the borrower makes an application to a mortgage broker who is independent of the FI. In some cases, particularly refinance transactions, the mortgage broker may solicit applications rather than rely on borrower requests. The broker, who can operate as an agent of the FI or of the borrower, orders the



credit report and may also order an appraisal and preliminary title work. The FI should ensure controls are in place to provide for an independent appraisal process. Brokers and applicants should be prevented from influencing the appraiser to ensure an independent valuation is obtained.

Once the broker has gathered the necessary application information, it is submitted along with supporting documentation to one or more FIs for underwriting. The FI's underwriter reviews the information and makes a credit decision. The FI should also perform all critical loan-processing activities, such as verification of income and employment. Time is of the essence, since the first FI that gives approval to the broker is often granted the loan, assuming the price is competitive.

The loan approval package, with papers prepared in the name of the FI, is then returned to the broker. The FI or broker schedules the closing which takes place in the same way as noted in the retail transaction. Alternatively, the package can be forwarded to a closing agent, typically selected by the FI or broker, who closes the loan. The closing agent selection should be made from the FI's approved list. Once the loan has closed, the completed package is returned either directly to the FI or to the broker who then delivers it to the FI. Again, the FI will review the loan for quality and either retain the loan in its own portfolio or sell it.

The agencies do not intend to limit arrangements that regulated institutions have with their mortgage brokers, provided that the arrangements do not place the agent in a conflict of interest that prevents the agent from representing the interests of the regulated institution.<sup>2</sup> Nonetheless, financial institutions that use mortgage brokers acting as their agents should have adequate policies, procedures, and controls to address: initial approval and annual re-certification, underwriting, pre-funding and QC reviews, repurchases, early prepayments, appraisals, quality and documentation monitoring, fraud, scorecards, timely delivery of loan packages, and utilization of contract underwriters. Automated fraud controls and checks, such as social security numbers, addresses, etc., are an efficient method for checking on the accuracy of borrower information and highlighting mismatches.

Third parties generate their income from mortgage origination volume and are incented to produce and close as many loans as possible. Thus, FIs should have adequate controls and procedures in place to ensure third parties are not compensated for incomplete or fraudulent mortgage applications. Fraudsters will intentionally target an FI that has a reputation for lax controls.

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<sup>2</sup> Appraisal Regulation preamble, page 29498, Federal Register, dated June 7, 1994.

**Mortgage Loan Purchased from a Correspondent** - In this transaction, the borrower applies for and closes his loan with a correspondent of the FI, which can be a mortgage company, small depository institution, or finance company. The correspondent closes the loan with internally generated funds in its own name or with funds borrowed from a warehouse lender. Without the capacity or desire to hold the loan in its own portfolio, the correspondent sells the loan to an FI. The purchasing FI is frequently not involved in the origination aspects of the transaction, and relies on the correspondent to perform these activities in compliance with the FI's approved underwriting, documentation, and loan delivery standards. The purchasing FI reviews the loan for quality prior to purchase. The purchasing FI must also review the appraisal or AVM report and determine that it conforms to the appraisal regulation and is otherwise acceptable. The loan can be booked in the FI's own portfolio or sold.

In "delegated underwriting" relationships, the FI grants approval to the correspondent to process, underwrite, and close loans according to the FI's processing and underwriting requirements. The FI is then committed to purchase those loans. Obviously, proper due diligence, controls, approvals, QC audits, and ongoing monitoring are warranted for these higher risk relationships.

Financial institutions that generate mortgage loans through correspondents should have adequate policies, procedures, and controls to address: initial approval and annual re-certification, underwriting, pre-funding and QC reviews, repurchases, early prepayments, appraisals, quality and documentation monitoring, fraud, scorecards, timely delivery of loan packages, and utilization of contract underwriters. In addition, FIs should have contractual agreements to demand and enforce repurchase proceedings and other disciplinary actions with correspondents delivering loans outside of product and other contractual agreements.

**Construction Transactions** add additional layers of participants and complexity, and therefore are not specifically detailed here. The following is a list of some of the third party participants to these transactions:

- Land Developer,
- General Contractor,
- Sub-contractors,
- Building Inspectors, and
- Development Lender.

There can be variations in all these participants and transactions based on local RE laws and practices. Private mortgage insurance

companies and government entities that sponsor guarantees and insurance programs are frequently additional participants to transactions. Since many FIs accept applications via the internet, there can be other participant and transaction variations from that activity.

Transaction flow narratives are graphically illustrated in Appendix B. Refer to these as needed while reading the following sections on mechanisms and fraudulent third party mortgage schemes.

## **APPRAISAL GUIDANCE**

Congress enacted Title XI of the Financial Institutions, Reform, Recovery and Enforcement Act of 1989 (FIRREA) requiring member agencies of Federal Financial Institutions Examination Council (FFIEC) to issue RE appraisal regulations to address problems involving faulty and fraudulent appraisals. One of the cornerstones of the regulation was a requirement that a regulated financial institution or its representative select, order, and engage appraisers for federally related transactions to ensure independence. The agencies' expectations on this subject are stated in an interagency statement dated October 27, 2003 entitled Interagency Appraisal and Evaluation Functions. This statement provides clarification of the various agencies' appraisal and RE lending regulations and should be reviewed in conjunction with them.

Specifically, the October 2003 statement primarily addresses the need for appraiser independence. A regulated institution is expected to have board approved policies and procedures that provide for an effective, independent RE appraisal and evaluation program. Basic elements of independence are discussed such as separation of the function from loan production and engagement of the appraiser by the institution, not the borrower. A written engagement letter is encouraged. An effective internal control structure is also necessary to ensure compliance with the agencies' regulations and guidelines. This includes a review process provided by qualified, trained individuals not involved with loan production. The depth of review should be based on the size, complexity, and other risk factors attributable to the transactions under review. For the full text of the October 27, 2003 statement please refer to Appendix G.

## **THIRD PARTY MORTGAGE FRAUD MECHANISMS**

There are a variety of mechanisms by which third party mortgage loan fraud can take place. Various combinations of these mechanisms may

be implemented in a single fraud. Some of these mechanisms and their uses are described in this section.

### **Collusion**

Collusion involves two or more individuals working in unison to implement a fraud. Various third parties may conspire to perpetrate a fraud against an FI with each generally contributing to the plan. Each person performs his respective role and receives a portion of the illicit proceeds. Often, but not always, third parties recruit or bribe FI employees to take part in the scheme. The scheme may also include additional parties not involved in the planning or aware of all participants, but who are still part of the plan's execution.

### **Documentation Misrepresentation**

Mortgage fraud is generally achieved using fictitious, forged, or altered documents needed to complete a transaction. Pertinent information may also be omitted from documents. The following describes some key documents and ways they can be altered to perpetrate fraud.

**Loan Application** - The application captures information needed for an FI to make a credit decision based on the borrower's qualifications such as financial capacity. It may include false information regarding the identity of the buyer or seller, income, employment history, debts, or current occupancy of the property. The information on the final application may have been altered and be materially different than that provided on the initial application.

**Appraisal** - An appraisal is a written statement that should be independently and impartially prepared by a qualified practitioner setting forth an opinion of the market value of a specific property as of a certain date, supported by the presentation and analysis of relevant market information. It is an integral component of the collateral evaluation portion of the credit underwriting process.

An appraisal is fraudulent if the appraiser knowingly intends to defraud the lender and/or profits from the deception by receiving more than a normal appraisal fee. This includes accepting a fee contingent on a foregone conclusion of value, or a guarantee for future business in response to the inflated value. The appraiser may inflate comparable values or falsify the true condition of the property, which can allow the defrauder to obtain a larger loan than the property

legitimately supports. An appraisal that does not include negative factors affecting the property value can influence the FI to enter into a transaction that it normally would not approve. The defrauder may use comparables that are outdated, fictitious, an unreasonable distance from the subject property, or materially different from the subject property. Photos represented to be of the subject property may be of another property. Inflated appraisal values create high loss potential and contribute to an FI's losses at the time of foreclosure or sale.

**Credit Report** - This document contains an individual's credit history which is used to analyze an individual's repayment patterns and capacity. Credit histories can be forged or altered through various methods to repair bad credit or create new credit histories. Fraudsters can also use the credit report of an unknowing individual who has a good credit record. Perpetrators have been known to scan and alter illegally obtained legitimate credit reports that are then printed and used as originals. Copiers can be similarly used to produce fictitious or altered credit reports. Fraudsters have used computers to hack into credit bureau files and have purchased credit bureau computer access codes from persons who work for legitimate businesses.

Alternate credit reference letters are often used for applicants with limited or no traditional credit history. They are usually in the form of a letter directly from a business such as a utility, small appliance store, etc., to which the applicant is making regular payments. These letters can be easily altered or completely fabricated using the business's letterhead. As lenders expand to provide loans to more diverse income levels, alternate credit references are becoming more common.

**Deed** - A deed identifies the owner(s) of the property. It can be altered to disguise the true property owner or the legitimate owner's signature can be forged to execute a mortgage transaction. Alteration or forgery of this document allows the fraudster to use a false identity to complete the transaction.

**Financial Information** - This includes financial statements, tax returns, FI statements, and income information provided during the application process. Any of this data can be falsified to enable the applicant to qualify for a mortgage loan. Inadequate income and employment verification procedures may allow mortgage loan fraudsters to deceive the FI regarding this

information. Some perpetrators have been known to set up phone banks to receive verification calls from FIs.

**HUD-1 Settlement Statement** - The HUD-1 accompanies all residential RE transactions. This is a statement of actual charges, adjustments, and cash due to the various parties in connection with the settlement. Working alone or with accomplices this document can be altered to defraud the parties to the transaction. Information on the original HUD-1 may show entities or persons not noted as lien holders but who still receive payoffs from seller's funds. These individuals may be deleted from the final HUD-1 that is available for review prior to loan closing. This enables individuals involved in the fraudulent scheme to receive funds from the loan disbursement without the FI being aware of such payments. The document may show a down payment when none was made. The document may also include the borrower's forged signature.

**Mortgage** - A mortgage is a legal agreement that uses real property as collateral to secure payment of a debt. In some locales a deed of trust is used instead. A mortgage can be altered to disguise the true property owner, the legitimate lien holder, and/or the amount of the mortgage. Alteration or forgery of this document allows the fraudster to obtain loan proceeds meant for another party or in an amount that exceeds the legitimate value of the property.

**Quitclaim Deed** - This is a document used to transfer the named party's interest in a property. The transferring party does not guarantee that he has an ownership interest, only that he is conveying the interest to which he represents he is entitled. Fraud perpetrators may use this document to quickly transfer property to straw or nominee borrowers without a proper title search. Straw borrowers are discussed on page 17 under Third Party Mortgage Fraud Schemes. This technique can disguise the true property owner and allow the mortgage transaction to be completed quickly.

**Title Insurance/Opinion** - Either of these documents confirms that the stated owner of the property has title to the property and has the right to transfer ownership of that property. They identify gaps in the chain of title, liens, problems with the legal description of the property, judgments against the owner, etc. Title insurance schedules or opinions can be altered to change the insured FI or omit prior liens. This can be part of the falsification that occurs when a perpetrator attempts to obtain multiple loans from different FIs for one mortgage

transaction. Alteration of title insurance or opinions occurs in other fraud scenarios, as well.

### **Identity Theft**

Identity theft means the theft of an individual's personal identification and credit information, which is used to gain access to the victim's credit facilities and FI accounts to take over the victim's credit identity. Perpetrators may commit identity theft to execute schemes using fake documents and false information to obtain mortgage loans. These individuals obtain someone's legitimate personal information through various means, i.e., obituaries, mail theft, pretext calling, employment or credit applications, computer hacking, and trash retrieval. With this information, they are able to impersonate homebuyers and sellers using actual, verifiable identities that give the mortgage transactions the appearance of legitimacy.

### **Mortgage Warehousing**

Mortgage warehousing lines of credit are used to temporarily "warehouse" individual mortgages until the mortgage banker, who may be acting as a broker, can sell a group of them to an FI. If a dishonest mortgage banker has warehousing lines with two FIs, he can attempt to warehouse the same mortgage loan on each line. The individual FIs may not be aware of the other's line. One FI may be presented with the original documents, while the delivery of the documents to the other FI is indefinitely delayed. The second FI may fund the line without the documents if previous dealings with the mortgage banker have been satisfactory. It is only after transferring funds that the second lender realizes it has been defrauded. The Mortgage Electronic Registry System (MERS) can also be used as a valuable control tool.

The mortgage warehouse lender often relies on the mortgage banker's internal loan data regarding FICO, loan-to-value (LTV), debt-to-income (DTI), appraised value, credit grade and aging, making them vulnerable to fraud if the provided data is not accurate. The mortgage warehouse lender should have proper procedures and controls to provide ongoing monitoring, verification, and audits of the loans under this line of credit. It may also want to consider scorecards, due diligence, and customer identification policies and procedures.

### **Negligence**

Negligence occurs when people who handle mortgage transactions are careless or inattentive to the accuracy and details of the documents or disregard established processing procedures. This often happens when an FI is experiencing fast growth and uses temporary and part-

time employees to process a large volume of mortgages without proper controls or oversight. Inattention to detail provides perpetrators with the opportunity to submit documents containing fraudulent information with the probability that the fraud will not be detected. Fraudsters may target FIs once they identify these weaknesses.

### **THIRD PARTY MORTGAGE FRAUD SCHEMES**

The purpose of this section is to describe some of the most prevalent types of mortgage fraud that have resulted in significant losses to FIs. Fraud schemes using one or more of the mechanisms described earlier are limited only by the imagination of the individuals who initiate them. The following scenarios are not intended to be an all-inclusive list. Specific examples for most of these schemes are detailed in Appendix C.

#### **Appraiser Fraud**

A person falsely represents himself as a State-licensed or State-certified appraiser. Appraiser fraud also can occur when an appraiser falsifies information on an appraisal or falsely provides an inaccurate valuation on the appraisal with the intent to mislead a third party or FI. Appraiser fraud is often an integral part of some fraud schemes.

#### **Builder Bailout**

A builder bailout usually occurs when a builder has sold the majority of homes in a tract or subdivision, but is left with some unsold homes. The builder may not want to bother with these last remaining properties or may feel a need to cover losses associated with the project. The builder may also be under pressure from an FI to repay the loans due to default status. To dispose of the remaining properties, the builder may utilize a variety of schemes that can include, but are not limited to, the use of a hidden seller with assisted financing as a front or the use of inflated property values.

In an effort to attract RE investors, the builder may promise the investor that he will continue to manage the properties as rentals and may offer to absorb any negative cash flow for the first 12 to 18 months. The builder may or may not honor the promise to manage the property. Income potential is frequently overstated and operating expenses understated in an attempt to entice innocent investors. As a result of the scheme, the unsuspecting FI is often left with a loan that has poor cash flow and over-valued collateral.



## **Chunking**

Chunking is a variation of a land flip (see page 16). The scheme begins with an unsophisticated borrower attending a seminar that purportedly shows how to get rich by investing in multiple rental properties. At or following the seminar, a third party contacts the unsuspecting borrower to encourage him to invest in a specific property or properties with no money down. The third party acts as an agent for the borrower and simultaneously submits loan applications on the borrower's behalf to multiple FIs for the various properties. The borrower may or may not know that the third party has submitted the application to multiple lenders. The assistance of an appraiser, broker, and/or a representative of a title company are usually required to ensure that the borrower does not have to bring money to the closings. The third party acts as an agent for the borrower during the closings and often, unbeknown to the borrower, pockets the loan proceeds. The unsophisticated borrower is left with numerous loans from various FIs and usually has insufficient cash flow to repay the debt. The FIs are forced to foreclose on the properties and can suffer sizeable losses because of the scheme.

## **Double Selling**

Double selling is a scheme wherein a mortgage loan broker accepts a legitimate application, obtains legitimate documents from a buyer, and induces two FIs to each fully fund the loan. In this scenario, the originator leads each FI to believe that the broker internally funded the loan for a short period. Since there is only one set of documents, one of the funding FIs is led to believe that the proper documentation will arrive any day. Double selling is self-perpetuating because different loans must be substituted for the ones on which documents cannot be provided to keep the scheme going. Essentially, the broker uses a lapping scheme to avoid detection.

Another variation of double selling entails a mortgage loan broker accepting a legitimate application and proper documentation, who then copies the loan file, and presents both sets of documents to two investors for funding. Under this scheme, the broker has to make payments to the investor who received the copied documents or first payment default occurs.

## **Equity Skimming**

Equity skimming, which is a federal crime, can occur in a variety of ways. The basic legal definition involves an individual engaging in a pattern of acquisition of residential rental RE through federal loan programs, failing to make payments, and diverting rental

proceeds for personal use. Since the individual fails to service the debt or properly maintain the property, a default occurs. Equity skimming may also take place in purchase or refinance transactions. The buyer need not be directly responsible for the debt to be guilty of this offense. Slumping economic conditions, property value deflation, and overbuilt markets present the best opportunities for equity skimming to occur since the number of financially distressed owners usually increases under these conditions. This scheme is frequently perpetrated by unscrupulous appraisers and closing agents.

One variation of equity skimming occurs when a purchaser obtains a loan using an inflated appraisal. By increasing the loan-to-value, the inflated appraisal allows the purchaser to obtain the property with little or no down payment. The borrower rents out the property and collects the rental payments, but fails to make mortgage payments or maintain the property. As time passes and the property deteriorates, the potential loss to the FI increases.

Another version of equity skimming happens when a potential purchaser locates a homeowner who is desperate to sell usually due to loan default or past due taxes. The skimmer/purchaser convinces the seller to take a second mortgage with payments to begin later, perhaps in 6-12 months. During this period, the skimmer makes no payments on the first or the second mortgage. By the time the seller realizes that he will not receive payments, the first mortgagee has begun foreclosure proceedings.

The skimmer's investment in the property is limited. Any profit is reduced by the amount of funds the skimmer is required to invest. Therefore, the skimmer will employ any method possible to entice the seller to pay closing costs, forgive a down payment, or take a second lien to cover those costs.

### **False Down Payment**

Another third party mortgage fraud involves false down payments. In this scenario, a borrower colludes with a third party, such as a broker, closing agent, etc., to reflect an artificial down payment. When this scheme is carried out with collusion by an appraiser, the true loan-to-value greatly exceeds 100% and has the potential to cause substantial loss to the FI.

### **Fictitious Mortgage Loan**

A fictitious mortgage loan scheme is perpetrated primarily by mortgage brokers, closing agents, and/or appraisers. In one version of this scheme, the identity of an unsuspecting person is assumed in

order to acquire property from a legitimate seller. The broker persuades a friend or relative to allow the broker to use the friend's or relative's personal credit information to obtain a loan. The FI is left with a property on which it must foreclose and the third parties pocket substantial fees from both the FI and buyer.

### **Land Flip**

A land flip is a scheme in which individuals, businesses, and/or straw buyers buy and sell properties among themselves. The sales price is inflated for each transaction to give the appearance of rapidly increasing property values. Mortgage loan advances increase with each purchase until the amounts of the mortgages greatly exceed the actual value of the property. This scheme is designed to extract as much cash as possible from the property, frequently for unrelated uses. The loan proceeds are often used for purposes not stated on the application. Land flip schemes may include fictitious leases designed to show that the properties are occupied by tenants thereby generating rental income to service the mortgage.

The most essential party in this scheme is the appraiser. This unscrupulous appraiser creates artificial comparables for each transaction to support the value needed for the loan. He may receive a high fee that comes from proceeds disbursed at closing or may be promised repeat business. The appraiser must appraise the properties in excess of the actual value, otherwise, there is no profit for the flip.

In another type of flip, a legitimate, unsuspecting buyer, may purchase the property after prior flips at an inflated price in excess of the true value of the property. The unsuspecting buyer is usually not knowledgeable of the true market value in the area in which he is purchasing, which makes him vulnerable to the scheme. This type of transaction can occur in geographic areas that are experiencing substantial property value appreciation, areas that are ideal retirement communities, or low-to-moderate income areas.

### **Phantom Sale**

The perpetrator may identify an apparently abandoned property and record a fictitious quitclaim deed to transfer the property into his name. Once the perpetrator has recorded the necessary document, he applies for and executes a loan. He pockets the loan proceeds and disappears. The transaction could also involve property obtained from another scheme. The FI is left with a mortgage loan that has no cash flow support and is collateralized by fraudulently obtained property.

## **Straw Borrower**

The straw borrower scheme involves the intentional disguising of the true beneficiary of the loan proceeds. The "straw", sometimes known as a nominee, may be used to:

- conceal a questionable transaction,
- replace a legitimate borrower who may not qualify for the mortgage or intend to occupy the property, or
- circumvent applicable lending limit regulations by applying for and receiving credit on behalf of a third party who may not qualify or want to be contractually obligated for the debt.

The straw borrower scheme is accomplished by enticing an individual, sometimes a friend or relative, to apply for credit in his own name and immediately remit the proceeds to the true beneficiary. The straw borrower may feel there is nothing wrong with this and fully believes that he is helping the third party. He expects the recipient of the loan proceeds to make the loan payments, either directly or indirectly. The recipient may be unable to or may never intend to make the payment. Over time, default would occur with the FI initiating foreclosure proceedings. This scheme can involve FI personnel, as well as other third party participants. The straw borrower may or may not be paid a fee for his involvement or know the full extent of the scheme.

In summary, millions of dollars have been lost because of the mortgage fraud schemes described above. These schemes produce many indicators that are apparent to an educated observer. The next section identifies these red flags and provides best practices that FIs can use to mitigate risk of loss.

## **RED FLAGS, INTERNAL CONTROLS, and BEST PRACTICES**

Prudent risk management practices for third-party originated loans are critical. Strong detective and preventive controls are an integral part of a sound oversight framework, including adequate knowledge of the FI's customers. Knowledgeable, trained employees, coupled with disciplined underwriting and proactive prevention controls, are an FI's best deterrent to fraud. Implementation of strong controls does not prevent human errors or oversight failures, but documentary evidence of QC measures taken by the FI can be a useful defense against a repurchase request from an investor.

As a part of the exam process, examiners should assess actions taken by the FI to document its controls over internal fraud, relative to safe and sound FI practices and individual agency regulatory

requirements. Examiners should also include Patriot Act and SAR requirements in their evaluations.

The following list of red flags<sup>3</sup>, which is not intended to be all-inclusive, may be used to identify and deter misrepresentations or fraud. Other automated systems for fraud detection, if used in conjunction with this list, are dependent on the quality of the input and analysis of the output. The presence of any of these red flags **DOES NOT** necessarily indicate that a misrepresentation or fraud has occurred, only that further research may be necessary.

### **Application**

The mortgage application is the initial document completed by the borrower that provides the FI with comprehensive information concerning the borrower's identity, financial position and employment history.

### **Red Flags**

- The application is unsigned or undated.
- Power of attorney is used. Investigate why the borrower cannot execute documents and if formal supporting documentation exists.
- Signatures on credit documents are illegible and no supporting identification exists.
- Price and date of purchase is not indicated.
- Borrower is selling his current residence, but does not provide documents to support a sale.
- Down payment is not in cash, i.e., source of deposit is a promissory note or repayment of a personal loan.
- Borrower has high income with little or no personal property.
- Borrower's age is not consistent with the number of years of employment.
- Borrower has an unreasonable accumulation of assets compared to income or has a large amount of unsubstantiated assets.
- Borrower claims to have no debt.
- Borrower owns an excessive amount of RE.
- New housing expense exceeds 150% of current housing expense.
- A post office box is the only indicated address for the borrower's employer.
- The same telephone number is used for the borrower's home and business.
- Application date and verification form dates are not consistent.

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<sup>3</sup> Many of these red flags are excerpted from material provided by Loan Cert of Glen Allen, VA.

<sup>5</sup> Many of these internal controls and best practice apply to correspondent lenders as well.

- Patterns or similarities are apparent from applications received from a specific seller or broker.
- Certain brokers are unusually active in a soft RE market.
- Concentration of loans to individuals related to a specific project is noted.
- Borrower does not guarantee the loan or will not sign in an individual capacity.
- Borrower's income is not consistent with job type.
- Employer is an unrealistic commuting distance from property.
- Years of education is not consistent with borrower's profession.
- Borrower is buying investment properties with no primary residence.
- Transaction resulted in a large cash-out refi as a percent of the loan amount.

### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides instruction on understanding common mortgage fraud schemes and recognizing red flags.
- √ Conduct pre-funding reviews on new production.
- √ Closely monitor new brokers, correspondents, and products. Scorecard criteria can be used to track performance. Typical tracking data includes: default rates, pre-purchase cycle times, loan quality indicators such as underwriting exceptions, and key data changes prior to approval.
- √ Verify the source of down payment funds by directly contacting the FI where funds are shown deposited.
- √ Closely analyze the borrower's financial information for unusual items or trends.
- √ Independently verify employment by researching the location and phone number of the business.
- √ Employ pre-funding and post-closing reviews to detect any inconsistencies within the transaction.
- √ Conduct risk based QC audits prior to funding.
- √ Ensure that prior liens are immediately paid from new loan proceeds.
- √ Assess the volume of critical post-closing missing documents, determine the potential for repurchase recourse, and evaluate reserve adequacy.
- √ Monitor RE markets from the locale in which the FI's mortgage loans originated.
- √ Establish a periodic independent audit of mortgage loan operations.
- √ Provide fraud updates/alerts to employees.

- √ Review patterns on declined loans, i.e., individual social security number, appraiser, RE agent, loan officer, broker, etc.
- √ Establish a fraud hotline for anonymous fraud tips.
- √ Increase the use of original supporting documentation on third party transactions, i.e., wholesale and correspondent originations.

## **Appraisals**

An appraisal is a written report, independently and impartially prepared by a qualified individual, stating an opinion of market value of a property as of a specific date.

### **Red Flags**

- The appraiser is a frequent or large volume borrower at the FI.
- The appraiser owns property in the project being appraised. This is a violation of the appraisal regulation and raises concerns about appraiser independence and bias.
- The most recent assessed tax value does not correlate with the appraisal's market value.
- An appraiser is used who is not on the institution's designated list of approved appraisers.
- The appraiser is from outside the area and may not be familiar with local property values. Understanding of local market nuances is critical to an accurate property valuation.
- An appraisal is ordered by a party to the transaction other than the FI, such as the buyer, seller, or broker.
- An appraisal is ordered before the sales contract is written.
- Certain information is left blank such as the borrower, client, or occupant.
- The appraised value is contingent upon curing some property defects, i.e., drainage problems or a zoning change.
- Comparables are not verified as recorded or are submitted by a potentially biased party, such as the seller or broker.
- Old comparables (9-12 months old) are used in a "hot" market.
- Comparables are an excessive distance from the subject property or are not in the subject property's general area.
- Comparables all contain similar value adjustments or are all adjusted in the same direction.
- All comparables are on properties appraised by the same appraiser.
- Unusual or too few comparables are used.
- Similar comparables are used across multiple transactions.
- Comparables and valuations are stretched to attain desired loan-to-value parameters.

- Excessive adjustments are made in an urban or suburban area when the marketing time is less than six months.
- Appreciation is noted in a stable or declining areas.
- Large unjustified valuation adjustments are shown.
- The land constitutes a large percentage of the value.
- The market approach greatly exceeds the replacement cost approach.
- Overall adjustments are in excess of 25%.
- Photos do not match the description of the property.
- Photos of comparables look familiar.
- Photos reveal items not disclosed in the appraisal, such as a commercial property next door, railroad tracks, etc.
- Items with the potential for negative valuation adjustments, i.e., power lines, railroad tracks, landfill, etc., are avoided in appraisal photos.
- Loan amounts are disclosed to the appraiser.
- File documentation is inadequate to determine whether appraisals were properly scrutinized or supported by additional appraisal reviews.
- The appraisal fee is based on a percentage of the appraised value.
- Independent reviews of external fee appraisals are never conducted.
- One or more sales of the same property has occurred within a specified period (6-12 months) and exceeds certain value increases (10% or more value increase).
- A fax of the appraisal is used in lieu of the original containing signature and certification of appraiser.

#### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides a good overview of common mortgage fraud schemes, the appraisal regulation, the RE lending standards regulation, appraisal techniques, and red flag recognition.
- √ Implement a strong appraisal and evaluation compliance review process that is incorporated into the pre-funding quality assurance program.
- √ Ensure reviewers identify violations of regulations and noncompliance with RE lending standards and other interagency guidance.
- √ Establish an approved appraiser list for use by retail, broker, and correspondent origination channels. This list should be generated and controlled by a unit independent of production.
- √ Obtain a current copy of each appraiser's license or certificate.
- √ Implement "watch" list and monitoring systems for appraisers who exhibit suspect practices, issues, and values. Include a post-closing review to detect any transaction inconsistencies.



- √ Establish a "suspended" or "terminated" list of appraisers who have provided unreliable valuations or improper practices.
- √ Implement controls to ensure that "terminated" appraisers are prohibited from engaging in future transactions with the FI, and its brokers and correspondents.
- √ Implement third party appraisal controls to ensure compliance with regulatory guidance, specifically as it applies to appraisals and evaluations ordered by loan brokers, correspondents, or other FIs.
- √ Develop appraisal requirements based on transaction risks.
- √ Statistically test the appropriateness of appraisals obtained by brokers and correspondents by obtaining independent AVMs and appraisals.
- √ Establish an independent appraisal review/collateral valuation unit to research valuation discrepancies and provide technical oversight.
- √ Review the appraisal's three-year sales history to determine if land flips are occurring.
- √ Perform detailed research on each appraiser's business history and financial condition.
- √ Physically verify the location and condition of selected subject properties and comparables.
- √ Monitor RE market values in areas that generate a high volume of mortgage loans and where concentrations exist.
- √ Employ pre- and post-closing QC reviews to detect inconsistencies within the transaction and hold production units financially accountable for proper documentation and quality.
- √ Conduct periodic independent audits of mortgage loan operations.

### **Credit Report**

A credit report is an evaluation of an individual's debt repayment history.

### **Red Flags**

- The absence of a credit history can indicate the use of an alias and/or multiple social security numbers.
- A borrower recently paying all accounts in full can indicate an undisclosed consolidation loan.
- Indebtedness disclosed on the application differs from the credit report.
- The length of time items are on file is inconsistent with the buyer's age.
- The borrower claims substantial income but only has credit experience with finance companies.
- All trade lines were opened at the same time with no explanation.

- A pattern of delinquencies exists that is inconsistent with the letter of explanation.
- Recent inquiries from other mortgage lenders are noted.
- AKA (also known as) or DBA (doing business as) are indicated.
- The borrower cannot be reached at his place of business.
- FI cannot confirm the borrower's employment.
- DTI ratios are right at maximum approval limits.
- Employment information/history on the loan application is not consistent with the verification of employment form.
- Credit Bureau alerts exist for Social Security number discrepancies, address mismatches, or fraud victim alerts.

### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides instruction on understanding common mortgage fraud schemes, analyzing credit reports, and recognizing red flags.
- √ Include an analysis of the credit report in the pre-funding quality assurance program.
- √ Make direct inquiries to the borrower and creditors to get an explanation of unusual or inconsistent information.
- √ Obtain an updated credit report if the one received is older than six months.
- √ Independently verify employment by researching the location and phone number of business.
- √ Implement a post-closing review to detect any inconsistencies within the transaction.
- √ Establish a periodic independent audit of mortgage loan operations.
- √ Define DTI calculation criteria and conduct training to ensure consistency and data integrity.
- √ Clarify non-borrower spouse issues, such as community property issues and the impact of bankruptcy and debts on the borrower's repayment capacity.
- √ Ensure lease obligations are reflected in borrower debts and repayment capacity.
- √ Conduct re-verification of credit to ensure accuracy of broker/correspondent provided credit reports.
- √ Obtain more than one report from multiple repositories available to corroborate the initial credit report if data appears questionable.

### **Escrow/Closing**

A closing or settlement is the act of transferring ownership of a property from seller to buyer in accordance with the sales contract.

Escrow is an agreement between two or more parties that requires certain instruments or property be placed with a third party for safekeeping, pending the fulfillment or performance of a specific act or condition.

### **Red Flags**

- Related parties are involved in the transaction.
- The business entity acting as the seller may be controlled by or is related to the borrower.
- Right of assignment is included which may hide the borrower's actual identity.
- Power of attorney is used and there is no documented explanation about why the borrower cannot execute documents.
- The buyer is required to use a specific broker or lender.
- The sale is subject to the seller acquiring title.
- The sales price is changed to "fit" the appraisal.
- No amendments are made to escrow.
- A house is purchased that is not subject to inspection.
- Unusual amendments are made to the original transaction.
- Cash is paid to the seller outside of an escrow arrangement.
- Cash proceeds are paid to the borrower in a purchase transaction.
- Zero funds are due from the buyer.
- Funds are paid to undisclosed third parties indicating that there may be potential obligations by these parties.
- Odd amounts are paid as escrow deposits or down payment.
- Multiple mortgages are paid off.
- The terms of the closed mortgage differ from terms approved by the underwriter.
- Unusual credits or disbursements are shown on settlement statements.
- Discrepancies exist between the HUD-1 and escrow instructions.
- A difference exists between sales price on the HUD-1 and sales contract.

### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides an understanding of common mortgage fraud schemes, proper closing procedures, and recognizing red flags.
- √ Provide the closing agent with instructions specific to each mortgage transaction.
- √ Instruct the closing agent to accept certified funds only from the FI that is the verified depository.
- √ Require the closing agent to notify the FI if the agent has knowledge of a previous, concurrent, or subsequent transaction involving the borrower or the subject property.

- √ Obtain a specific transaction closing protection letter from the closing agent.
- √ Implement controls to ensure loan proceeds fully discharge all debts and prior liens as required.
- √ Employ pre- and post-closing reviews to detect any inconsistencies within the transaction.
- √ Conduct periodic independent audits of mortgage loan operations.
- √ Use IRS form 4506 on all loans to facilitate full investigation of future fraud allegations.

### **Mortgage Brokers**

A mortgage broker is an individual who, for a fee, originates and places loans with an FI or an investor but does not service the loan.

#### **Red Flags**

- No attempt is made to determine the financial condition of the broker or obtain references and background information.
- A close relationship exists between the broker, appraiser, and lender, raising independence questions.
- The broker acts as an advocate for the borrower instead of serving as the FI's representative/agent.
- High "yield spread premiums" are paid by the FI.
- Original documents are not provided to the funding FI within a reasonable time.
- An unusually high volume of loans with maximum loan to value limits have been originated by one broker.
- An uncommonly large number of foreclosures, delinquencies, early payment defaults, prepayments, missing documents, fraud, high-risk characteristics, QC findings, or compliance problems exist on loans purchased from any broker.
- A large volume of loans from one broker arrives using the same appraiser.
- High repurchase volume exists for a specific broker.
- Numerous applications from a particular broker are provided possessing unique similarities.
- A high volume of loans exist in the name of trustees, holding companies, or offshore companies.
- An unusually large increase is noted in overall volume of loans during a short time period.

#### **Internal Controls/Best Practices<sup>5</sup>**

- √ Conduct an initial acceptance review and obtain documentation to support broker approval. Examples of actions to be taken include:

- o Review the broker's financial information as stringently as for other RE borrowers.
  - o Ensure the FI's broker agreements require brokers to act as the FI's representative/agent.
  - o Independently verify the broker's background information by checking business history outside of given references.
  - o Obtain a new credit report for the broker and check for recent debt at other FIs.
  - o Obtain resumes of principal officers, primary loan processors, and key employees.
  - o Conduct state license verification.
  - o Conduct criminal background checks and adverse data base searches, i.e., MARI (fraud repository).
- √ Conduct an annual re-certification of brokers.
  - √ Conduct pre-funding reviews on all new production utilizing a pre-funding checklist.
  - √ Conduct QC underwriting reviews.
  - √ Base broker compensation incentives on something other than loan volume, i.e., credit quality, documentation completeness, prepayments, fraud, and compliance.
  - √ Establish measurable criteria that trigger recourse to the broker, such as misrepresentation, fraud, early payment defaults, failure to promptly deliver documents, and prepayments (loan churning).
  - √ Hold brokers and third party contract underwriters responsible for gross negligence, willful misconduct, and errors/omissions that materially restrict salability or reduce loan value.
  - √ Establish a broker scorecard to monitor volume, prepayments, credit quality, fallout, FICO scores, LTVs, DTIs, delinquencies, early payment defaults, foreclosures, fraud, documentation deficiencies, repurchases, uninsured government loans, timely loan package delivery, concentrations, and QC findings.
  - √ Perform detailed vintage analysis, and track delinquencies and prepayments by number and dollar volume.
  - √ Closely monitor the total number of loans and products from a single broker.
  - √ Establish an employee training program that provides instruction on understanding common mortgage fraud schemes and the roles of a mortgage broker, as well as recognizing red flags.
  - √ Establish a periodic audit of the brokered mortgage loan operations with specific focus on the approval process.
  - √ Perform social security number validation procedures to validate borrower identity.

### **Title Insurance/Opinion**

Title insurance refers to an insurance policy that protects the holder, lender and/or owner, from loss sustained by defects in the

title. When a property is purchased, a lender and/or owner would require a title search and a title report (opinion), a document stating the status of the title such as the existence of liens, easements, covenants, or other claims and defects.

### **Red Flags**

- The seller either is not on the title or is not the same as shown on the appraisal or sales contract.
- The seller owned the property for a short time with cash out on sale.
- The buyer has a pre-existing financial interest in the property.
- The chain of title includes the buyer, realtor, or broker.
- The title insurance or opinion was prepared for and/or mailed to a party other than the lender.
- Income tax or similar liens are noted against the borrower on refinances.
- Delinquent property taxes exist.
- A notice of default is recorded.
- A modification agreement is apparent on an existing loan(s).
- A judgment exists against the borrower and is not shown on the credit report.
- Lien holders are not shown on HUD-1.
- The title policy is not issued on the property with the lien or on the whole property.
- Faxes of documents are used rather than originals or certified copies.

### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides instruction on understanding common mortgage fraud schemes, evaluating title insurance/opinions, and recognizing red flags.
- √ Include a review of the title commitment in the pre-funding quality assurance program.
- √ Review the final title policy and check for discrepancies with the original title commitment.
- √ Compare the final title policy with other closing documents, like the HUD-1, to ensure consistency regarding the first lien holder, lien amount, property size and location, and other pertinent information.
- √ Employ a post-closing review to detect any inconsistencies within the transaction.
- √ Establish a periodic independent audit of mortgage loan operations.

## Verification of Employment (VOE)

Verification of employment is an independent corroboration of an individual's employment and income to substantiate what an applicant has reported on his mortgage application.

### **Red Flags**

- Similarities in names, like the seller and applicant, are noted.
- The verification source is inappropriate, i.e., secretary or relative.
- The VOE is not on original letterhead or a standard FNMA/FHLMC form.
- The VOE is completed the same day it is ordered, indicating it may have been hand-carried or completed before the initial application date.
- An illegible signature exists with no further identification provided.
- The employer uses only a mail drop or post office box address.
- The employer is out of town which may signal a nonexistent firm.
- The business entity is not in good standing with the State or registered with applicable regulatory agencies.
- An overlap exists with current and prior employment.
- The borrower changed professions in moving to current employer.
- Excessive praise is noted in the remarks section of response.
- Round dollar amounts are used in year-to-date or past earnings.
- Income is not commensurate with stated employment, years of experience, or type of employment.
- Income is primarily commission based which can indicate self-employment.
- The borrower is a business professional which can be another indication of self-employment.
- The borrower's interest in the property is not logical given its distance from the place of employment.
- The borrower has a recent large increase in income or started a new job for which he does not appear qualified.
- Forms received contain last minute changes.
- Faxes of documents are used in lieu of originals.

### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides instruction on common mortgage fraud schemes, performing proper VOE, and recognizing red flags.

- √ Detail specific employment verification procedures in the pre-funding quality assurance program.
- √ Independently verify employment by researching the location and phone number of the business.
- √ Ensure the address information on W-2 forms and tax returns match data provided on the application.
- √ Determine if the employer is within a logical distance from subject property.
- √ Employ a post-closing review to detect any inconsistencies within the transaction.
- √ Establish a periodic independent audit of mortgage loan operations.

### **Verification of Deposit (VOD)**

Deposit verification is an independent assessment of the status of an individual's depository accounts to corroborate what an applicant has reported on his mortgage application.

#### **Red Flags**

- The VOD is completed on the same day it was ordered.
- Deletions or cross outs exist on the VOD.
- No date stamp was affixed to the VOD by the depository to indicate the date it was received.
- The buyer has no deposit accounts, but a VOD is in the file.
- The deposit account is not in the borrower's name or is a joint account with a third party.
- The borrower's account balance at the FI is insufficient to close the transaction.
- The deposit account is new or has a round dollar balance.
- The closing check is drawn on a different FI.
- An existing loan is secured by the checking or savings account.
- An illegible signature exists with no further identification provided.
- Significant balance changes are noted in depository accounts during the two months prior to the date of verification.
- The checking account balance is excessive versus the savings account balance.
- The checking account's average two-month balance exactly equals the present balance.
- Funds for the down payment are only on deposit for a short period.
- Young borrowers have a substantial amount of cash in the FI.
- A low-income borrower has a large amount of cash in the FI.
- An IRA is shown as a source of down payment funds.



- The down payment source is held in a non-depository "depository," such as an escrow trust account, title company, etc.
- An escrow receipt is used as verification which may have been from a personal check not yet cleared, or a check returned due to insufficient funds.
- The VOD is not folded indicating it may have been hand carried.
- The VOD is not on original FI letterhead or a recognized form.

#### **Internal Controls/Best Practices**

- √ Establish an employee training program that provides instructions on common mortgage fraud schemes, performing proper VOD, and recognizing red flags.
- √ Detail specific deposit verification procedures in the pre-funding quality assurance program.
- √ Independently verify the legitimacy of the depository by researching its location and phone number.
- √ Validate borrower provided information on the application by making direct inquiries to the depository regarding the account's name, age, average balance, number of monthly transactions, recent large dollar transactions, etc.
- √ Employ a post-closing review to detect any inconsistencies within the transaction.
- √ Establish a periodic independent audit of mortgage loan operations.

#### **OTHER**

##### **Red Flags**

- Critical loan processing activities, such as verification of income, employment, or deposit, is delegated to brokers.
- Delegated underwriting allowed for correspondents that are new or lack an established track record with the FI.
- A growing number of loans is being repurchased due to misrepresentations by the FI under purchase and sale agreements with secondary market investors. The originating FI may suffer significant financial losses in the event of a large and unforeseen fraud.
- Third party mortgage loan fraud is not covered in standard fidelity bond insurance.
- Tax returns show RE taxes paid but no property is identified as owned.
- Alimony is paid but not disclosed.
- Evidence of white out or other document alterations is observed.
- Type or handwriting varies from other loan file documents or handwriting is the same on documents that should have been prepared by different people or entities.

### **Internal Controls/Best Practices**

- √ Review purchase and sales agreements with brokers, correspondents, and secondary market investors to determine if general representations and warranties contain appropriate fraud and misrepresentation provisions.
- √ Determine the FI's responsibility for repurchasing and putting back loans that were funded based on misrepresentations.
- √ Check whether an endorsement or rider exists to the fidelity bond that provides coverage of third party mortgage fraud.
- √ Regularly document the FI's review of insurance coverage.
- √ Establish procedures to ensure the bonding company is notified of a possible claim within the policy's specified period.
- √ Adopt detailed policies and procedures to ensure effective controls are in place to set, validate, and clear conditions prior to final approval processes.
- √ Base underwriter compensation on loans reviewed and not loans approved.
- √ Establish effective pre-funding and post QC programs that include sampling, portfolio analysis, appraisal, and income/down payment verification practices.
- √ As a part of the pre-funding QC process, use AVMs to corroborate appraised values.
- √ Employ internally developed or vendor-provided fraud detection software.
- √ Institute corporate wide fraud awareness training.
- √ Perform due diligence of brokers and correspondents. Understand the risks in their policies, procedures, and practices before transacting business.
- √ Determine how and when the FI reserves for fraud and ensure compliance with FAS 5.
- √ Review the FI's litigation roster for existing and potential class actions, and threatened litigation that may highlight a problem with a particular broker, correspondent, or internal practices.
- √ Review whistleblower and hot line reports, which may indicate fraudulent activities.

### **DISCOVERY AND FOLLOW-UP RELATING TO SUSPICIOUS TRANSACTIONS**

Growing risk and increasing losses make it prudent for FIs and their regulators to take a more proactive stance in discovering fraud. For the regulatory agencies, the possible existence of such fraud may be discovered at any time during the examination process. When

fraud is discovered or suspected, examiners should conduct appropriate on-site procedures, including expanded loan file review and investigation using a risk based approach.

### **Expansion of the Review**

**Examiners should consult with the appropriate level of agency management prior to any expansion of scope for this purpose. This is particularly important when another regulated institution or regulatory agency is involved, i.e., another institution is a purchaser of the loans. Any additional actions taken should be in accordance with respective agency guidelines. This is also important when a law enforcement agency is involved.**

Expansion of the review can encompass a wide variety of actions, including additional on-site procedures by examiners, the involvement of fraud or other subject matter experts, and the initiation of the respective agency's formal investigative process. The particular circumstance of the event will dictate the steps necessary to develop evidentiary support for actions a regulatory agency may decide to take. The procedures an examiner undertakes should be developed in discussion with his immediate management.

Additional on-site review frequently takes the form of expanded loan file review. Early payment default reports, QC review results, and data on other high-risk attributes can aid in the selection of the expanded sample. If all or most of the loans in question originated from one source such as a broker or correspondent, further review of that source's activity may be warranted. Robust scorecards can provide a wealth of information on an FI's brokers and correspondents. These tools can help pinpoint the most likely source of possible fraud.

Once the expanded loan sample has been selected, examiners can review documentation, trace proceeds, and utilize other procedures to determine if fraud has occurred. To the extent possible, examiners should obtain original documents rather than copies. On-site inspection of real property can be a critical source of additional information. These inspections might reveal discrepancies in the information contained in the appraisal, such as nonexistent property, property appearance, (size, number of stories, dimensions, etc.), property use, surrounding area, and general condition. Early detection of a fraud scheme involving multiple loans can mitigate substantial losses.

If the FI has had significant repurchase requests involving one originator, it should promptly commence an internal investigation. If not, the examiner may need to select a sample for review. Since

the loans may not be on the FI's books, the examiner should request details of sold pools that contain the desired originators' loans to select for further investigation.

### Documentation

With the first suspicion of fraud, examiners should collect and copy all relevant documents pertaining to the transaction. This comprises all critical loan documents that support the allegation of fraud, identification of the parties involved, their roles, and documents used in the disbursement of funds. The timely assembly of supporting documentation is crucial.

The following tips may aid examiners in gathering documents in a condition that will support an administrative, civil, or criminal action:

- Retain a copy of the entire document or file, not just the pages that include the relevant information. This will protect against the effects of altered documents or file contents later.
- Copy both sides of records such as checks, notes, and general ledger tickets. The information on the reverse sides of these records may be relevant to the case. Moreover, copying both sides of these records will protect against subsequent counterfeits by others. When on-line processing systems are used to post debits and credits, screen prints showing trace and batch numbers for both sides of these records should be obtained.
- Do **not** write or make marks on the documentation. Such writing or marks can jeopardize the integrity, authenticity, and admissibility of those documents as evidence.
- Immediately document the receipt date when a record is obtained along with the name and title of the person from whom the record was received.
- Use flowcharts and other graphics in documenting the case. This practice can help others, including agency attorneys, other examiners, law enforcement, and administrative law judges, visualize the transactions and gain a better understanding of the case.
- Make sure copies of documents and records are legible.
- Label, date, and index all documentation. The organization of documents should mirror the flow of events they support.

- **If in doubt**, make and retain a copy of the record. It will be more difficult and time consuming to go back later and may protect against subsequent destruction of relevant records.
- Request that the institution place special controls over records, when the potential exists for record alteration or destruction. **However, make sure to consult with your supervisor and legal counsel before taking steps to seal or control institution records.**

If the institution's loan files do not reveal the identities of all participants in the mortgage process, the examiners should establish these identities, if possible. In order to satisfy such a request, the institution might need to seek information or documents from the third party suspected of the fraud. Examiners should be cautious about revealing their suspicions of third parties, since this can provide premature notice. An alternative source of information to establish the identity of the parties involved may be through a review of public records.

### Interviewing

Following assembly and initial analysis of the documents, the examiner-in-charge (EIC) should determine the relevant institution employee(s) to question. Particular care should be given to the possibility that an employee has colluded with a third party in the fraud. In this situation, the employee should not be interviewed immediately. Instead, the EIC should consult with his supervisor or fraud expert to determine an appropriate strategy for the situation.

In this situation, interviews should be conducted using a pre-planned strategy. In preparation for the interview, the appropriate law enforcement authority should be contacted by a suitable level of agency management to determine if a criminal investigation is in progress.

The interview should not be conducted alone. A second examiner should accompany the interviewer to assist with taking notes and act as a witness. Participation by the accompanying examiner can be crucial to support the accuracy and completeness of the responses, as well as to add follow-up questions and explore additional areas. The purpose of the interview should be to gather information.

Interviews of people and entities outside the institution may also be appropriate, but these interviews are usually conducted as part of a formal investigation process. This could include, for example, borrowers, mortgage brokers, and their employees. Inquiry into the institution's relationship to these other entities can indicate they may fit within the definition of an institution-affiliated party

(IAP). In any event, EICs should follow their agency's procedures prior to contacting such outsiders. These procedures may include the involvement of agency attorneys to initiate the regulatory body's formal investigation process. In addition, examiners need to consider whether recommendation of administrative enforcement action against the institution or IAPs is appropriate.

### **Suspicious Activity Reports (SARs)**

The FI has responsibilities in fraud detection and reporting that will not only guide law enforcement but also the regulatory examination. As soon as the FI has a reasonable belief that fraud has occurred, it is required to file a Suspicious Activity Report (SAR) in accordance with the SAR regulation and form. Each agency has regulations requiring its respective FIs to report suspicious activities, and all agencies now use the uniform interagency SAR form. This form lists a variety of suspected offenses, including violations of federal criminal law, Bank Secrecy Act, and money laundering offenses. In addition, all FI regulators have regulations that require insured institutions and service corporations to file SARs. The SAR form and instructions for completion and filing may be found at [www.fincen.gov](http://www.fincen.gov).

Experience has shown that some institutions file SARs without prodding or suggestion, while others require varying degrees of direction from the examiners. If the FI has internally discovered fraud and filed a SAR prior to the examination, the agency's inquiry into the fraud can begin promptly upon its initiation of the examination.

When a SAR has been filed, the examiner's first step should be to obtain the supporting documentation that provided the basis of the SAR. The documentation should be reviewed for completeness and adequacy of support for the activity described in the SAR. Next, the examiner should discuss the SAR with the preparer listed on the form. Any missing or subsequently submitted documentation should be requested at this point. Additional investigative activities should be determined in consultation with the examiner's manager.

### **Referrals to State Appraiser Boards**

When an FI files a SAR because of suspected fraud involving a state licensed appraiser, it should also make a referral to the State Appraiser Board of the suspected fraud if appraisals are at issue. The state would then conduct an investigation of the suspected fraud and determine if the situation warrants action against the appraiser. The actions against the appraiser could range from fines to revocation of his license or certificate.

## **CONCLUSION**

Third party RE mortgage fraud presents a growing risk with increasing losses for FIs. It is essential that FIs have adequate controls and procedures, as well as ongoing monitoring in place to ensure the appropriateness of all third party relationships. Institutions and examiners should be as proactive as possible in regard to detection, investigation, and deterrence of this problem.

## APPENDIX A

### Glossary

**Abstract:** A summarized listing of all deeds and other papers constituting the chain of title to any real property. This is usually prepared by an attorney-at-law.

**Appraiser:** One who is expected to perform valuation services competently and in a manner that is independent, impartial, and objective. This person provides written valuation of real property.

**Borrower:** One who receives funds in the form of a loan with the obligation of repaying the loan in full with interest. The borrower can be purchasing the property, refinancing an existing mortgage, or borrowing against the equity of the property for other purposes.

**Broker Scorecard/Report Card:** A document that captures key performance and early warning indicators for loans submitted by brokers, such as volume, fallout, delinquency, early payment default, prepayments, credit quality, FICO scores, loan-to-value ratios, debt-to-income ratios, documentation deficiencies, uninsured government loans, repurchases, foreclosures, fraud, timely loan package delivery, concentrations, and QC findings.

**Building Inspector:** An individual or entity that provides written or photographic evidence that attests to the condition of the property.

**Closing:** The culmination of any RE transaction in which the interested parties or their representatives meet to execute documents, exchange funds and property and, if necessary, register the transfer of title.

**Closing Costs:** Moneys expended by a party in completing a RE transaction, over and above the purchase price, including: legal fees, taxes, mortgage application charges, mortgage insurance premium, interest adjustments, registration fees, appraisal fees, title insurance premium, etc.

**Closing/Settlement/Escrow Agent:** An individual or company that oversees the consummation of a mortgage transaction at which the note and other legal documents are signed and the loan proceeds are disbursed. Title companies, attorneys, settlement agents, and escrow agents can perform this service. Local RE law may dictate the party conducting the closing.

**Correspondent:** A mortgage banker who originates mortgage loans that are sold to other mortgage bankers or FIs.



## APPENDIX A

### Glossary

**Deed:** The document by which title to real property is transferred or conveyed from one party to another. See Quitclaim and Warranty deed.

**Deed of Reconveyance:** A transfer of a legal title from the trustee back to the trustor (the borrower) after the deed of trust is paid in full.

**Deed of Trust:** A type of security instrument in which the borrower conveys title to real property to a third party (trustee) to be held in trust as security for the lender, with the provision that the trustee shall re-convey the title upon the payment of the debt. Conversely, the third party will sell the land and pay the debt in the event of default by the borrower. See Mortgage and Deed of Reconveyance.

**Developer:** A person or entity who prepares raw land for building sites, constructs buildings, creates residential subdivisions or commercial centers, rehabilitates existing buildings, and performs similar activities.

**Escrow Instructions:** Instructions prepared by a lender and/or underwriter to direct the progression of a mortgage closing transaction from start to finish.

**Fannie Mae:** The commonly used name for the Federal National Mortgage Association (FNMA), a government sponsored entity that, as a secondary mortgage institution, is the largest single holder of residential mortgages in the United States. Fannie Mae primarily buys conforming conventional residential mortgages from primary lenders.

**Form 1003:** The standardized loan application form used in residential mortgage transactions.

**Form 4506:** An IRS form that taxpayers execute to authorize the IRS to release past tax returns to a third party. Many lenders require mortgage applicants to execute this form in order to verify income.

**Fraud:** A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his detriment.

**Freddie Mac:** The commonly used name for the Federal Home Loan Mortgage Corporation (FHLMC), a government sponsored entity that provides a secondary market for conforming conventional residential mortgages by purchasing them from primary lenders.

## APPENDIX A

### Glossary

**Ginnie Mae:** The commonly used name for the Government National Mortgage Association (GNMA), a government sponsored entity that provides sources of funds for residential mortgages, insured or guaranteed by the FHA or VA.

**Hawk Alert:** A notation at the bottom of a credit report indicating that some items of identification, i.e., Social Security number, address, etc., are associated with past fraudulent activities. For example, an address may be flagged because the previous occupant allegedly used the property for financial misbehavior.

**HUD-1 Form:** A standardized form prescribed by the Department of Housing and Urban Development that provides an itemization listing of funds paid at closing. Items that appear on the statement include RE commissions, loan fees, points, taxes, initial escrow amounts, and other parties receiving distributions. The HUD-1 statement is also known as the "closing statement" or "settlement sheet."

**Institution-affiliated Party:** The persons or entities that are subject to the jurisdiction of the federal FI regulatory agencies. These three categories of parties include: (1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution; (2) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate federal regulatory agency, by regulation or case-by-case, who participates in the conduct of the affairs of an insured depository institution; and (3) any independent contractor, including any attorney, appraiser, or accountant, who provides professional services for the institution.

**Lapping:** A fraud that involves stealing one customer's payment and then crediting that customer's account with a subsequent customer's payment.

**Modification Agreement:** A document that evidences a change in the terms of a mortgage loan. Common reasons for modification agreements are changes in interest rate, repayment terms, guarantors, or property securing the mortgage.

**Mortgage:** A conveyance of real or personal property to a person called a mortgagee (FI), to secure the repayment of money by the mortgagor (borrower) that becomes void upon the performance of such act.

## APPENDIX A

### Glossary

**Mortgage Banker:** An individual or firm that originates, purchases, sells, and/or services loans secured by mortgages on real property.

**Mortgage Broker:** An individual or firm that receives a commission for matching borrowers with lenders. Mortgage brokers typically do not fund the loans they help originate.

**Mortgage Fraud:** A knowing misrepresentation of the truth or concealment of a material fact in a mortgage application to induce another to approve the granting of a mortgage. For the purpose of this paper, mortgage fraud refers solely to fraudulent schemes pertaining to residential mortgages.

**Nominee Loan:** A loan made to one individual in which the proceeds of the loan benefit another individual without the knowledge of the lender.

**Nonaffiliated Third Party:** Any entity that is not an affiliate of, related by common ownership, or affiliated by common corporate control with the FI funding a mortgage loan. This does not include a joint employee of such institution.

**Originator:** The individual or entity that gathers application data from the borrower.

**Overage:** Selectively increasing the price of a mortgage loan above the FI's established rate to certain customers, and/or charging them higher than customary points and fees. The overage amount is generally split between the originator and the FI. See Yield Spread Premium.

**Pretext Calling:** A scheme associated with identity theft in which a fraudster, pretending to represent a legitimate entity, calls an unsuspecting party seeking personal identification data, such as social security account numbers, passwords, or other forms of account information. The fraudster then uses this information to assume the identity of the unsuspecting victim. Among other things, the fraudster can obtain a mortgage in the name of the unsuspecting victim.

**Quitclaim Deed:** A deed that transfers without warranty whatever interest or title, if any, a grantor may have at the time the conveyance is made. A grantor need not have an interest in the property to execute a quitclaim deed.

## APPENDIX A

### Glossary

**Real Estate Agent:** An individual or firm that receives a commission for representing the buyer or seller, typically in a RE purchase transaction.

**Representations and Warranties:** Provisions within purchase and sale agreements between buyers and sellers of loans that detail conditions of purchase/sale and remedies for misrepresentations and noncompliance with the contract.

**Secondary Market:** The buying and selling of existing mortgages, usually as part of a "pool" of mortgages.

**Third Party:** The parties necessary to execute a residential mortgage other than an FI and a legitimate borrower. Third parties include, but are not limited to, mortgage brokers, correspondents, RE appraisers, and settlement agents.

**Title Company/Abstract Company:** Entity that researches recorded ownership of and liens filed against real property and then issues a title insurance policy guaranteeing the lien position of the lender, or provides a title opinion. Some states still require an attorney opinion supported by an abstract.

**Title Insurance:** An insurance policy that indemnifies the lien position of a lender against losses associated with property interests not disclosed in the title opinion. The borrower can also obtain this coverage by purchasing a separate policy.

**Title Opinion:** An examination of public records, laws, and court decisions to ensure that no one except the seller has a valid claim to the property, and to disclose past and current facts regarding ownership of the subject property.

**Underwriting:** The credit decision-making process can be automated, manual, or a combination of both. In an automated process, application information is entered into a decision-making model that makes a credit determination based on pre-determined criteria. In a manual process, an individual underwriter, usually an employee of the FI, makes the credit decision after evaluating all of the information in the loan package, including the credit report, appraisal, and verifications of deposit, income, and employment. FIs often use a combination of both, with the automated decision representing one element of the overall credit decision. In each case, the decision may include stipulations or conditions that must be met before the loan can close.

APPENDIX A  
Glossary

**Verification of Deposit:** Written document sent to the borrower's depository institution to confirm the existence of a down payment or cash reserves.

**Verification of Employment:** Written document sent to the borrower's employer to confirm employment/income. Employment is often reconfirmed by calling the employer prior to funding.

**Warehouse Lender:** A short-term lender for mortgage bankers. Using mortgages as collateral, the warehouse lender provides interim financing until the mortgages are sold to a permanent investor.

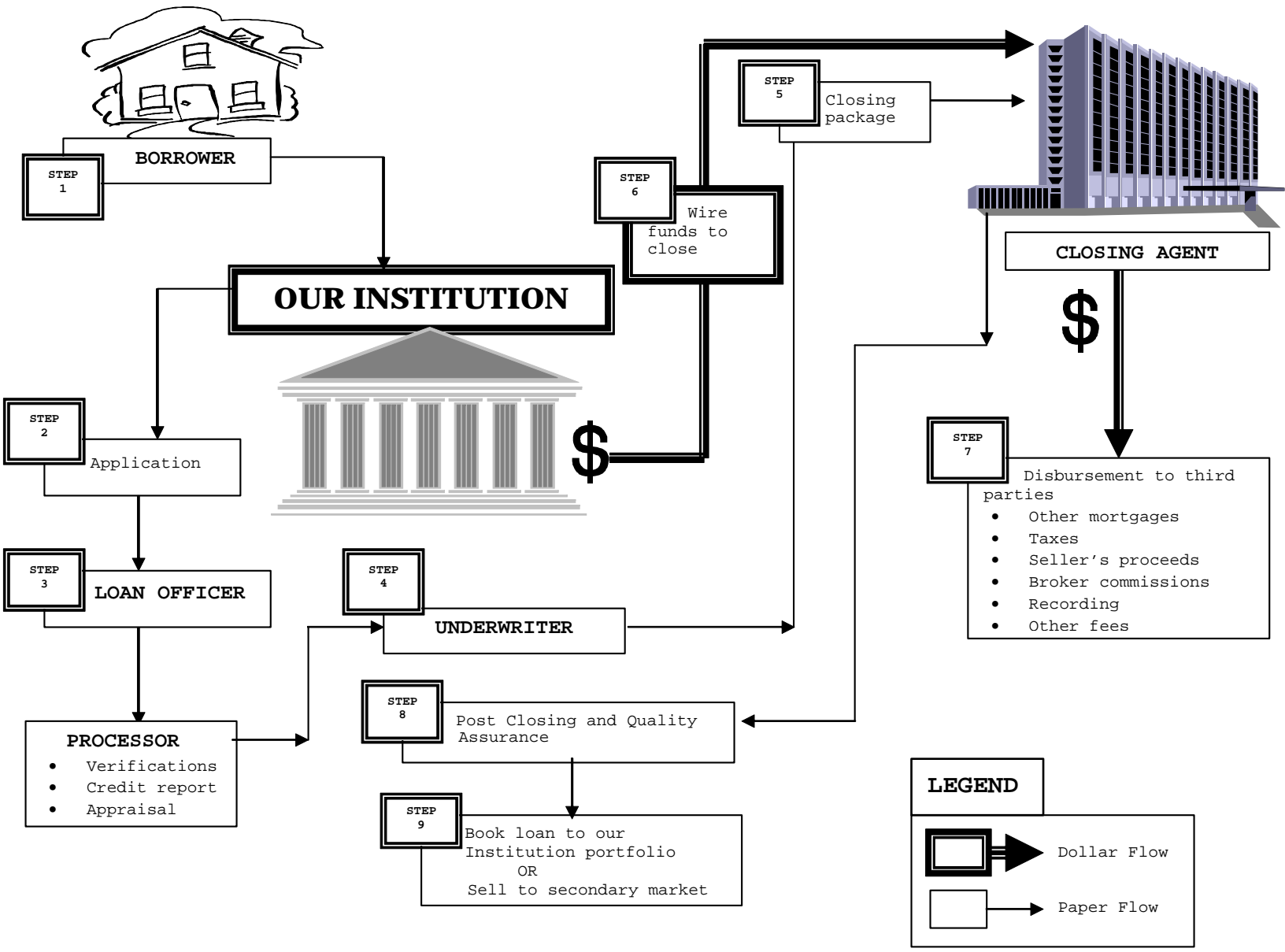
**Warehouse (Loan):** In mortgage lending, loans that are funded and awaiting sale or delivery to an investor.

**Warehouse Financing:** The short-term borrowing of funds by a mortgage banker based on the collateral of warehoused loans. This form of interim financing is used until the warehoused loans are sold to a permanent investor.

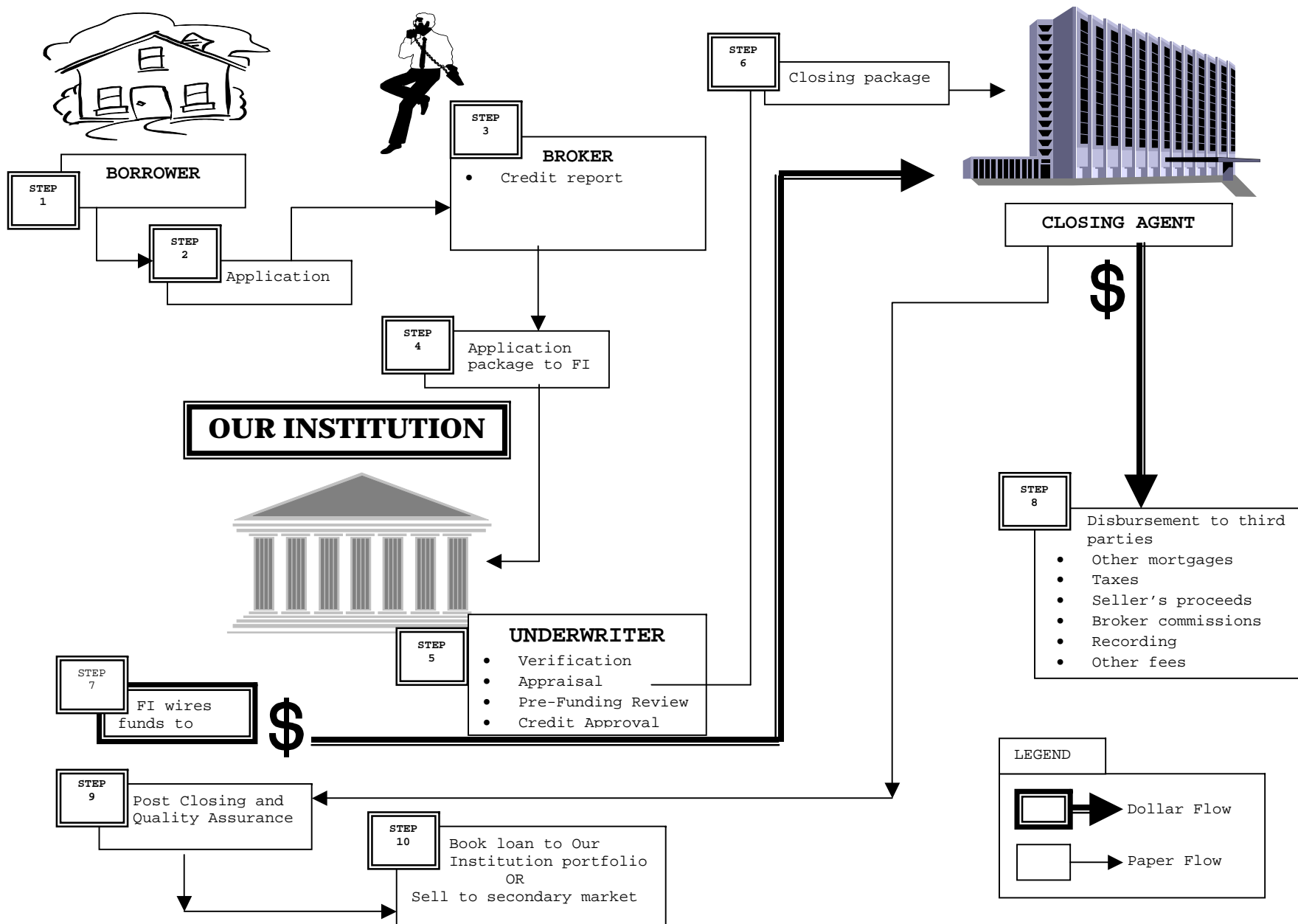
**Warranty Deed:** A deed warranting that the grantor has a good title free and clear of all encumbrances and will defend the grantee against all claims against the property.

**Yield Spread Premium:** A payment to a mortgage broker from the lender for originating and processing a loan with a fractionally higher interest rate than the lender normally is prepared to offer borrowers (an "above-par" loan). A yield spread premium should reduce the normal origination points and fees the lender has established for a par rate mortgage loan. Also referred to as "Servicing Release Premiums", "Additional Compensation Paid by Lender", "Par Plus Premiums", "Premium Pricing" and/or "Volume Based Compensation." See Overages.

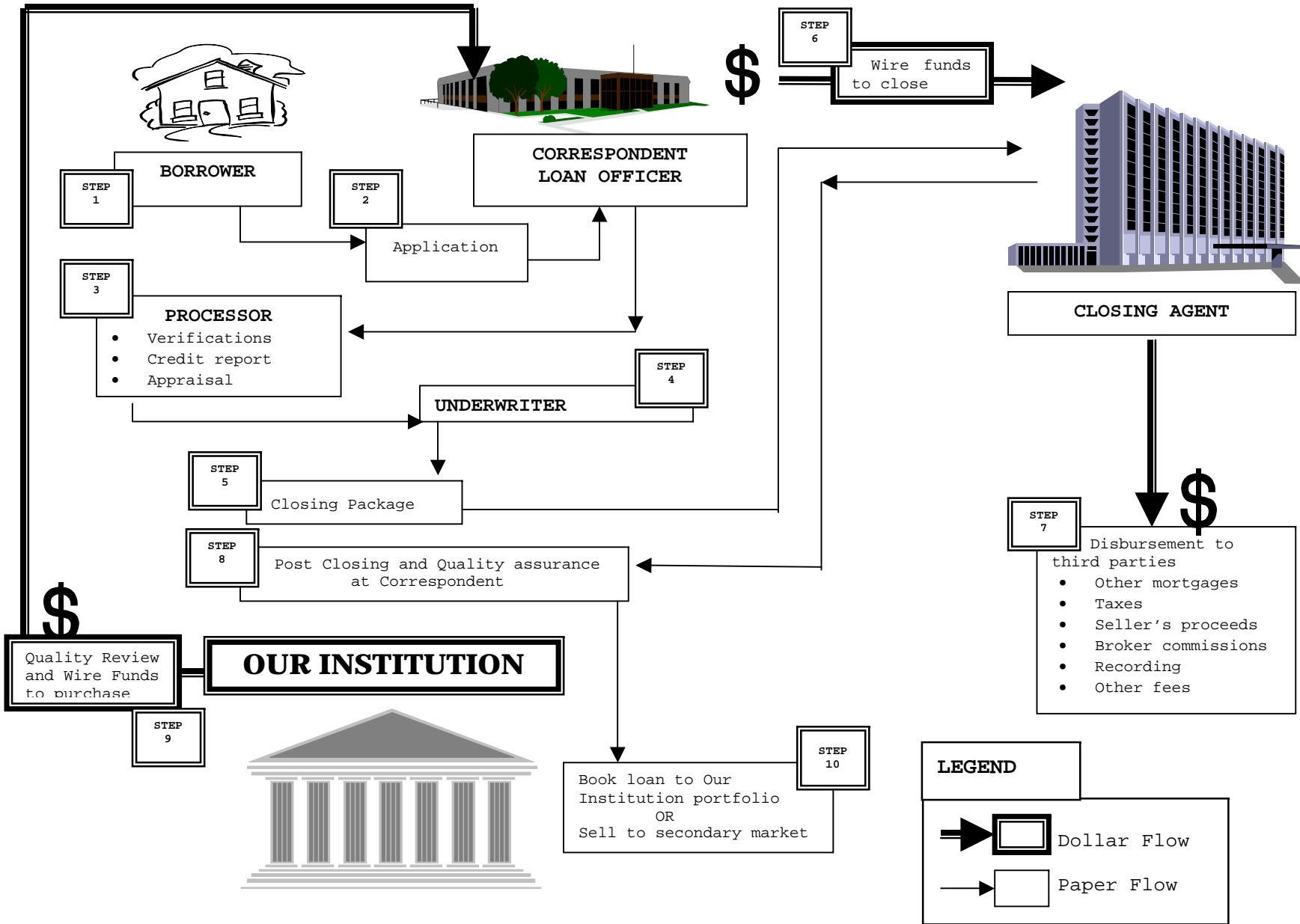
# BASIC RETAIL TRANSACTION



# INDEPENDENT BROKER TRANSACTION



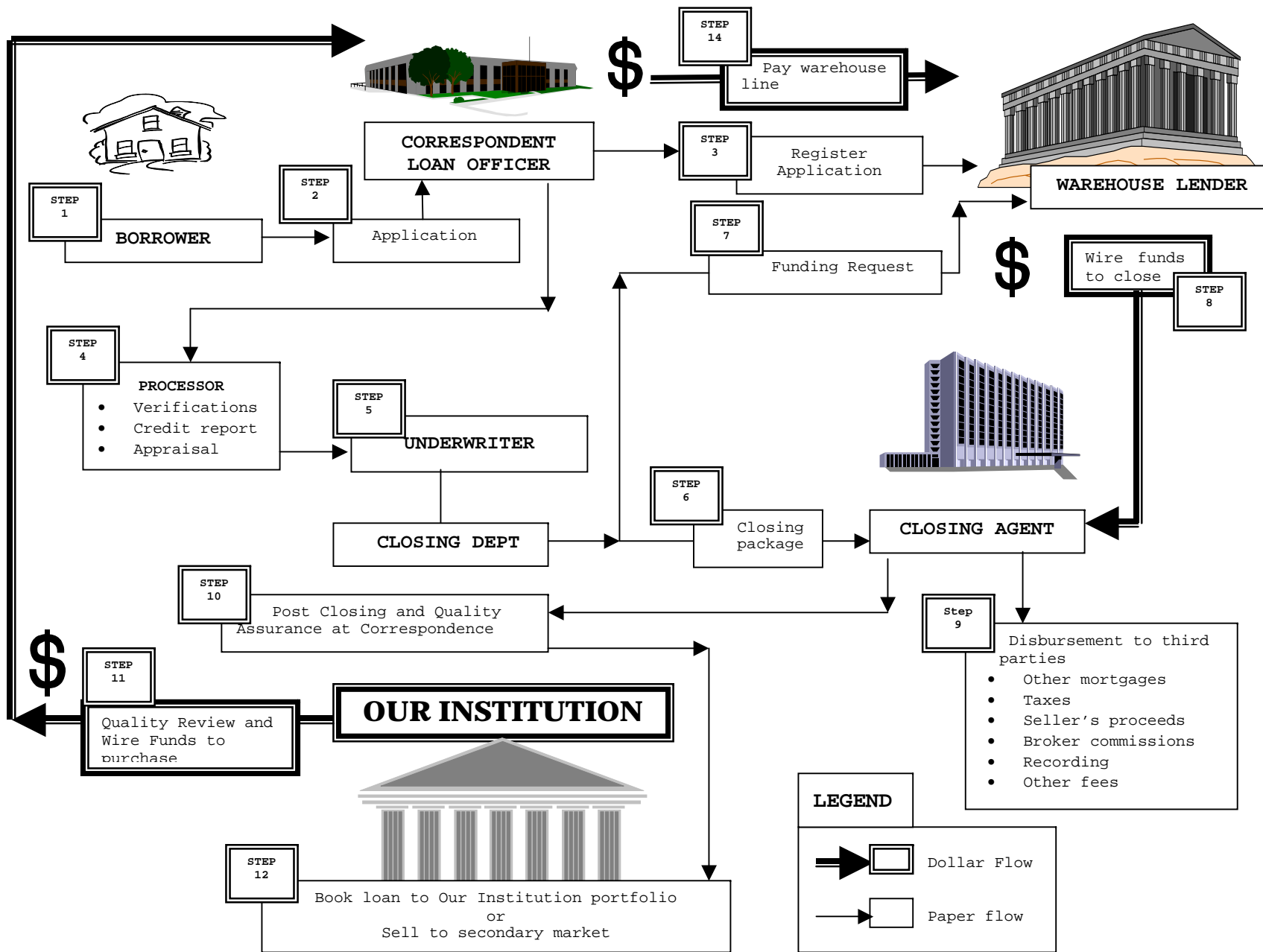
# CORRESPONDENT WITH IN-HOUSE FUNDS



45



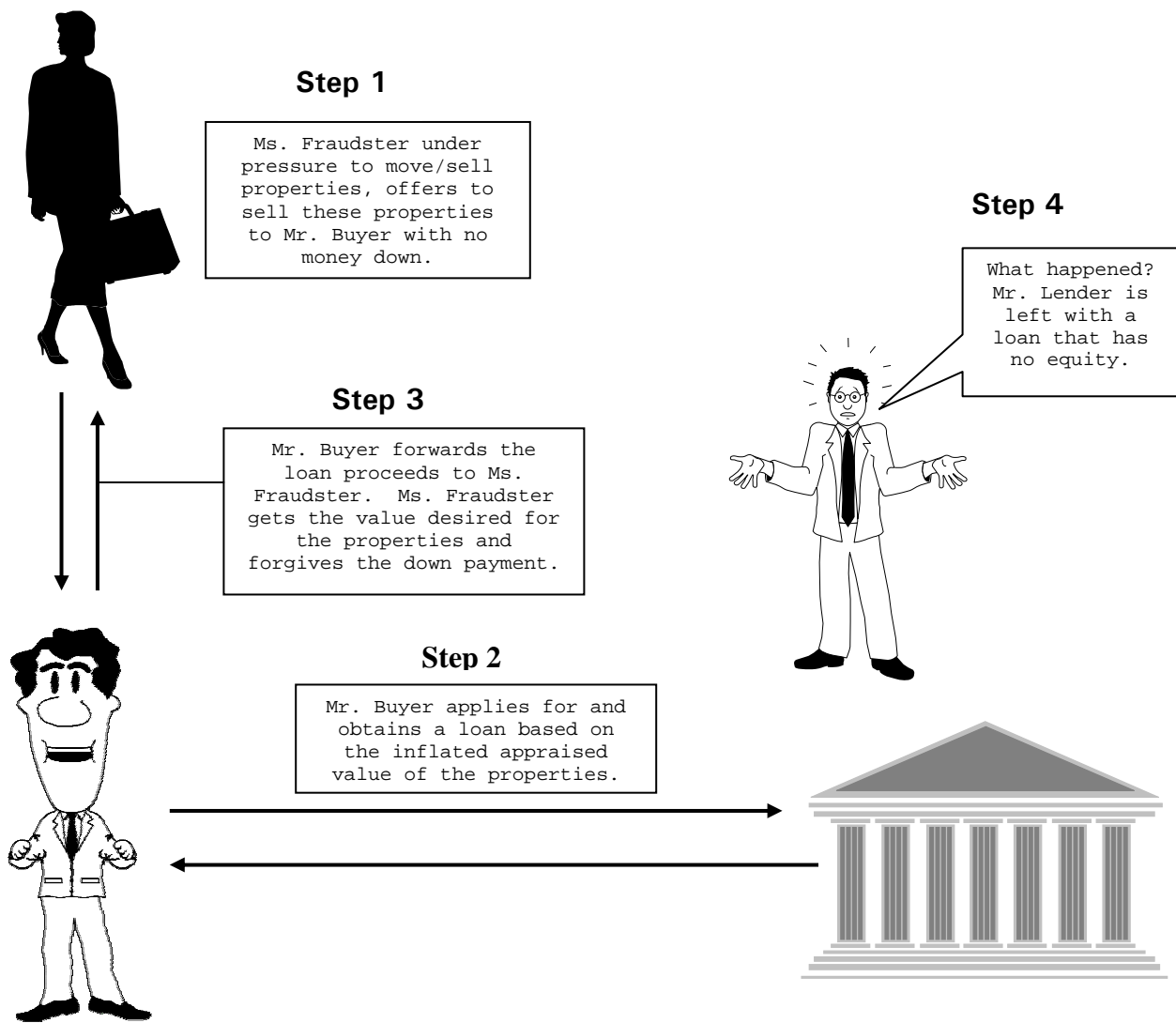
# CORRESPONDENT WITH WAREHOUSE FUNDS



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Builder Buyout**

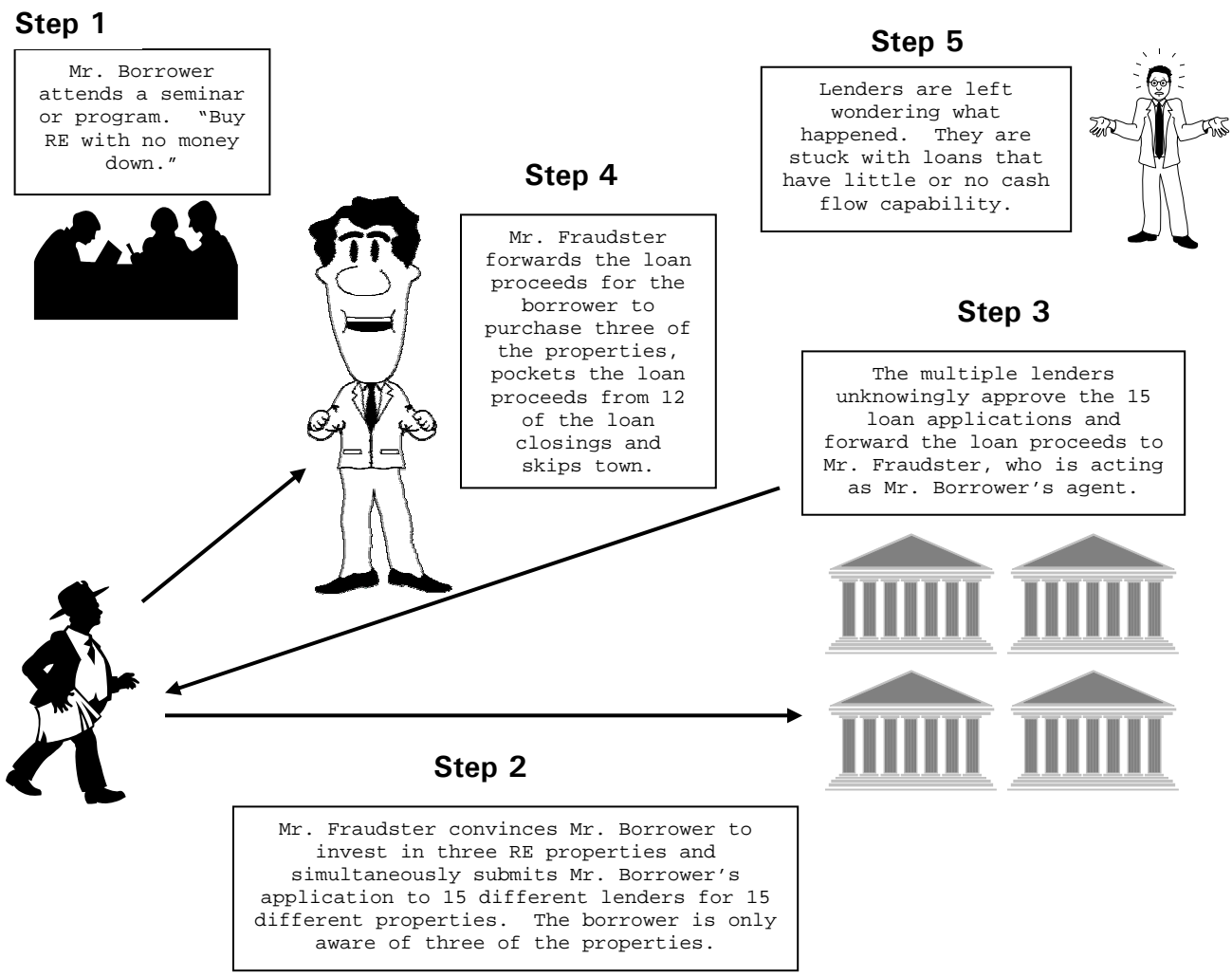
The builder/developer, Ms. Fraudster, offers a home to Mr. Buyer and offers to finance the borrower's down payment. The property is worth \$100,000; however, Ms. Fraudster sells the property to Mr. Buyer for \$120,000 based on a fraudulent appraisal. This enables Mr. Buyer to borrow the entire value of the home (\$100,000). Ms. Fraudster forgives the down payment. The net effect is that Ms. Fraudster gets what she wants for the property and the buyer gets 100% financing. When the home goes to foreclosure, there is no equity to protect the lender and the resulting losses are disproportionately large for the lender.



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Chunking**

Mr. Borrower attends a "seminar" or program that shows how to get rich by investing in RE with no money down. A third party, Mr. Fraudster, possibly a presenter at the seminar/program, encourages Mr. Borrower to invest in three RE properties and acts as Mr. Borrower's counsel/agent. Under Mr. Fraudster's guidance, Mr. Borrower completes the required application documentation for the transactions. Unbeknownst to Mr. Borrower, Mr. Fraudster takes the applications and submits the information to 15 different lenders for 15 different properties. This scheme requires the assistance of an appraiser, broker, and/or a representative of a title company to ensure that Mr. Borrower does not have to bring money to the multiple closings. Mr. Fraudster acts as an agent for Mr. Borrower at the 15 different closings. The net effect is that Mr. Borrower receives loan proceeds from three of the closings and Mr. Fraudster pockets loan proceeds from 12 of the 15 closings. The lenders are stuck with loans to a borrower who does not have the ability to repay the debt and are often forced to foreclose on the properties.



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Double Selling**

A Broker, Ms. Fraudster, obtains a loan application from legitimate homebuyers. When all the paperwork is complete, and the loan is ready for funding, Ms. Fraudster transfers the entire package to Investor A and Investor B. Both investors wire the funds needed for closing to Ms. Fraudster, who is also serving as the closing agent. Ms. Fraudster uses the proceeds from one of the investors to purchase the home for the legitimate homebuyers and pockets the proceeds from the other investor.

**Step 4**

Ms. Fraudster pockets the ill-gotten funds from one of the investors and uses the funds from the other to legitimately purchase the RE property on behalf of the homebuyers.

**Investor A**



**Step 3**

Both investors approve the homebuyers' loan application and forward loan proceeds to Ms. Fraudster who is also acting as the closing agent. Neither Investor A, nor Investor B knows that Ms. Fraudster has submitted the loan application to another investor.

**Step 2**

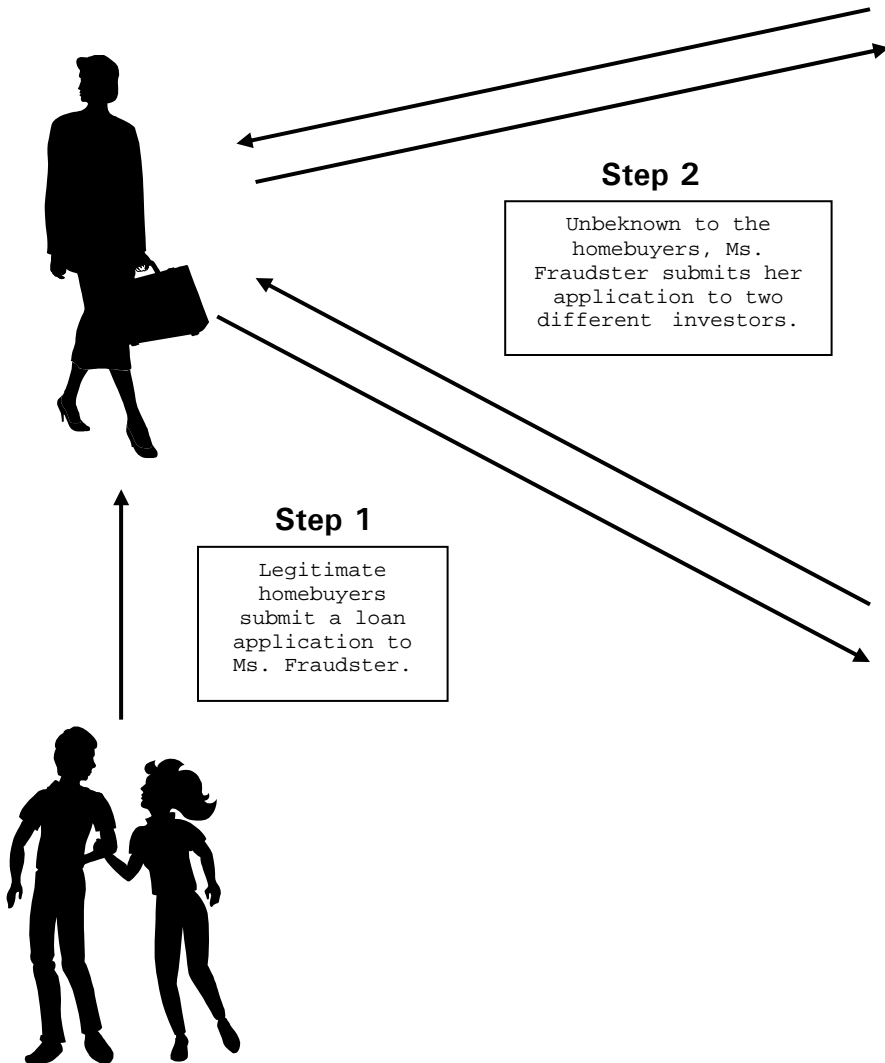
Unbeknownst to the homebuyers, Ms. Fraudster submits her application to two different investors.

**Step 1**

Legitimate homebuyers submit a loan application to Ms. Fraudster.



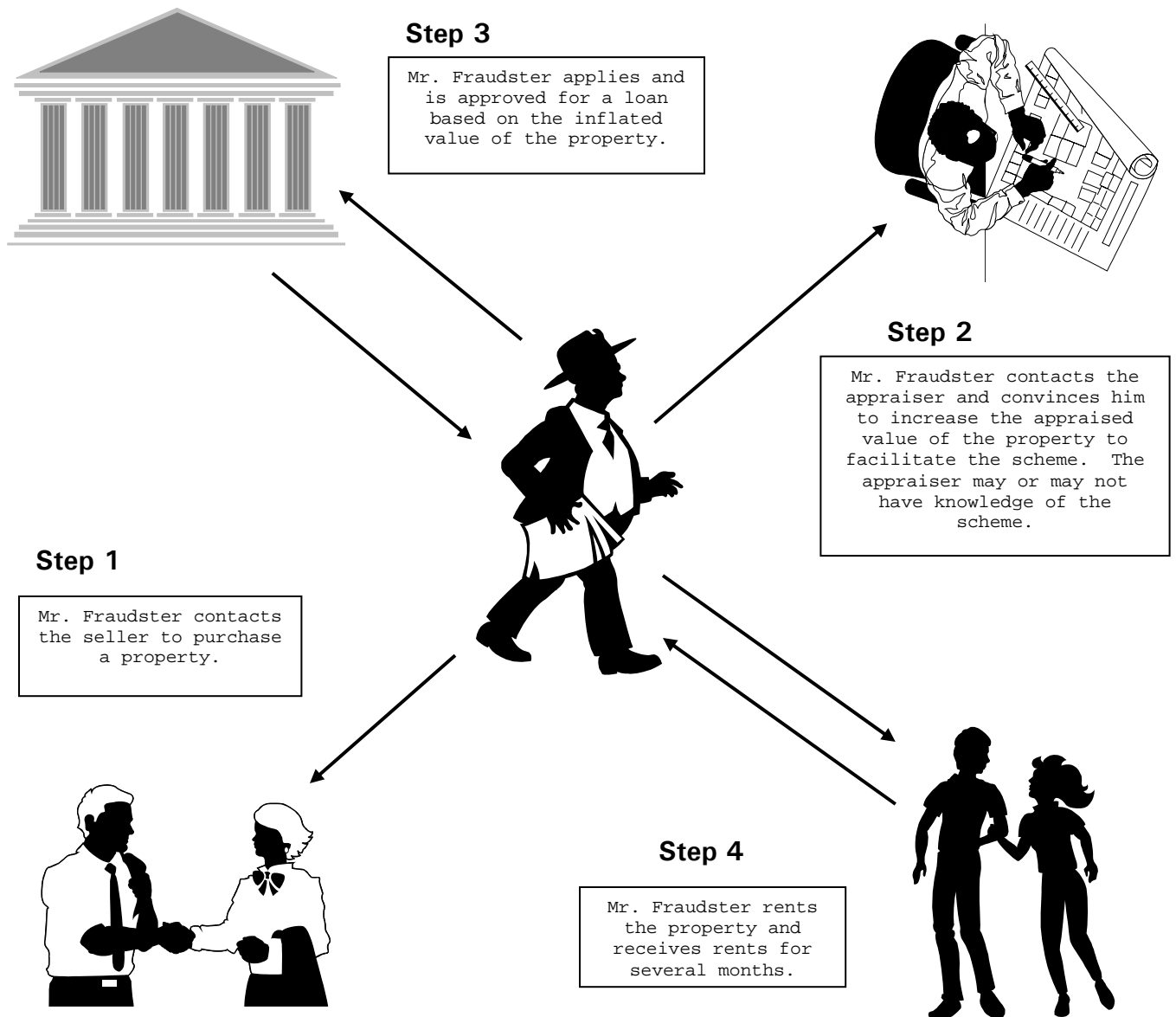
**Investor B**



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Equity Skimming**

A third party, Mr. Fraudster, contacts Mr. Seller about purchasing his home. After an agreement is reached, Mr. Fraudster contacts an appraiser friend to appraise the property at a value higher than current market rates. Mr. Fraudster then presents XYZ Bank with the signed contract and appraisal, and secures funding with an unrealistically low loan-to-value. Mr. Fraudster rents the property to an unsuspecting person, who, often times, pays a year's rent in advance at a discounted rate. Mr. Fraudster never makes a payment on the loan and skips town with the rent proceeds, leaving XYZ Financial Institution with a loan, which has a higher than expected, loan-to-value, and subsequent loss.



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**False Down payment**

A third party, Mr. Fraudster, needs or wants to sell his home, but has no desire to move. To perpetrate this scheme, Mr. Fraudster needs a straw borrower with a substantial down payment. In order for this loan to fund, there must be an appearance of a down payment equal to 20% of the purchase price. To give the appearance of the down payment, Mr. Fraudster contacts his associate at a local title company. The associate provides a check, drawn on the associate's escrow account, in the name of a straw buyer. The check is subsequently deposited back into the associate's escrow account. Mr. Fraudster then falsifies the closing documents in order to complete the transaction. The false down payment allows the straw borrower and Mr. Fraudster to complete the scheme. Mr. Fraudster continues to reside in the home.

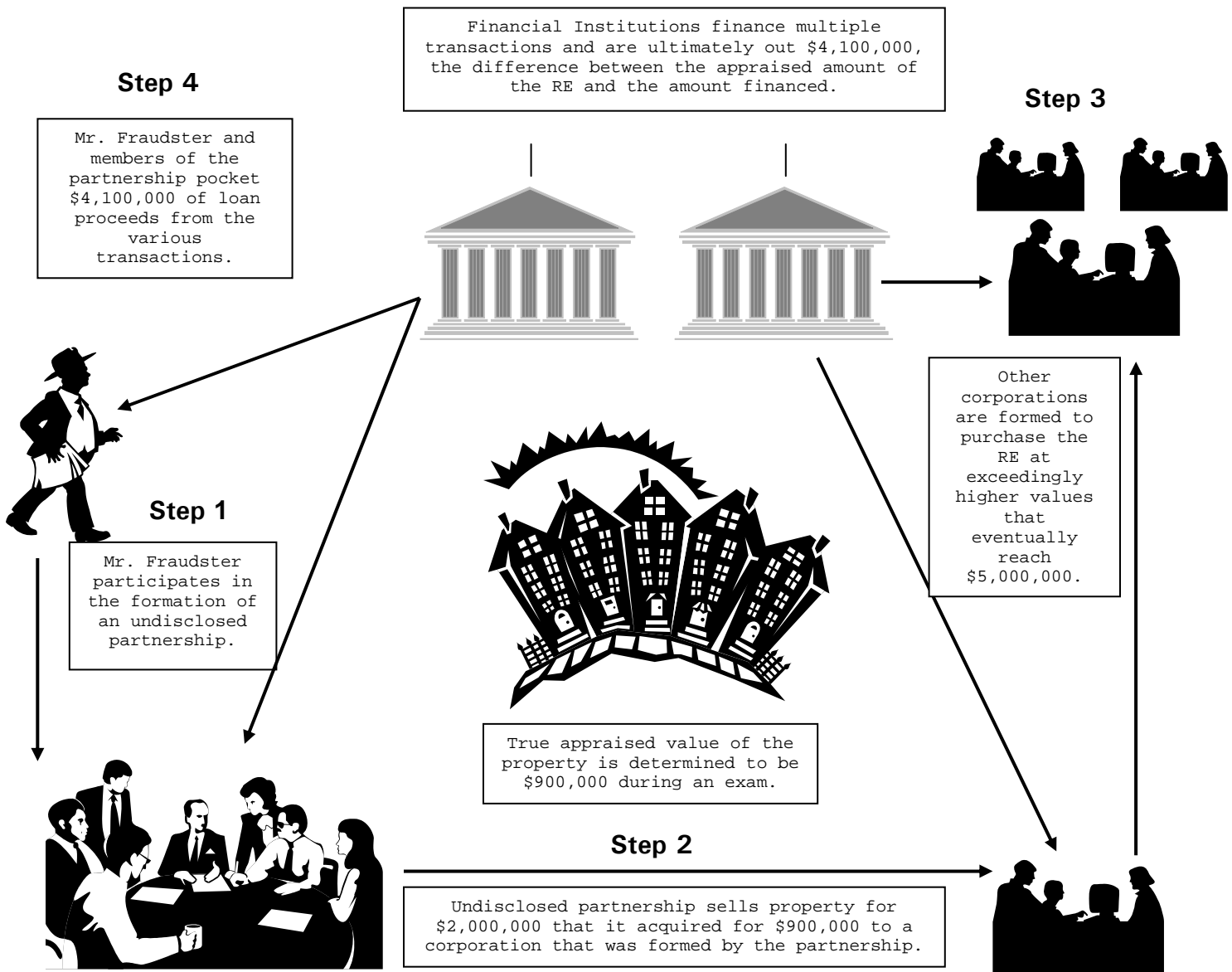
**Fictitious Loans**

A fictitious loan scheme is perpetrated primarily by unscrupulous loan brokers, title companies, and/or appraisers. Under this scheme, an unsuspecting person's identity is assumed to acquire real property from a legitimate seller. A broker, Mr. Fraudster, persuades a friend or relative to allow him to use the friend's or relative's personal information to obtain a loan. After the scheme is complete, the FI is left with a property on which it must foreclose, and Mr. Fraudster pockets substantial fees from both the FI and the "buyer".

APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Land Flip**

The property owner, Mr. Fraudster, has an undisclosed partnership interest in an apartment complex with several other individuals. The most recent valuation of the RE is \$900,000. The partners establish a separate corporation and decide to sell the RE to the corporation for \$2 million, thereby affecting the return of their initial investment. A bogus appraisal is obtained with which Mr. Fraudster processes the loan to the new corporation. Subsequently, other corporations are formed to purchase the RE at exceedingly higher values, each time providing the appraiser additional fees and the owner's additional cash from their initial investment. During a future regulatory examination, the appraisal is criticized and an independent appraisal ordered. The FI finds that the property is only worth \$900,000 and is inadequate to cover the current loan outstanding of \$5 million.



APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Phantom Sale**

Prior to the loan closing, Mr. Fraudster may forge either a deed of reconveyance or a release of lien, which is then recorded under Mr. Fraudster's name. Mr. Fraudster applies for credit using the RE property that is now recorded under Mr. Fraudster's name. The lender does a title search on the property. Unfortunately for the lender, the title search shows that Mr. Fraudster has title free and clear. Since there is no existing lien on record, 100% of the loan proceeds go to the scam artist.

In many cases, the property may be acquired using a non-existent "straw buyer." Since Mr. Fraudster is often the middleman, he does not have to worry about having the funds traced back to him. Mr. Fraudster simply cashes the proceeds of the loan check and disappears.

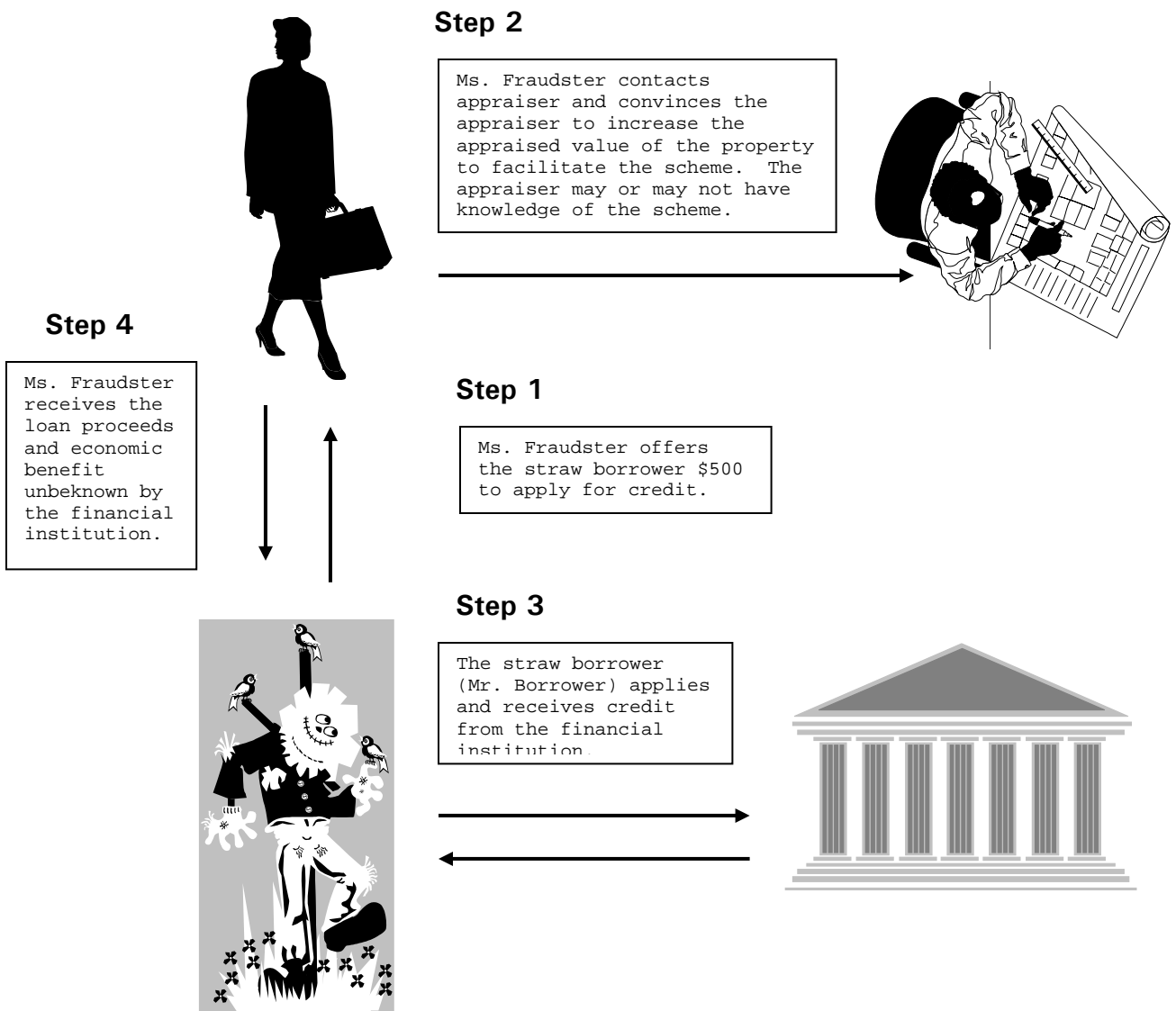


APPENDIX C  
Fraudulent Third Party Mortgage Schemes

**Straw Borrower**

Due to lending limit regulations or poor credit, Ms. Fraudster no longer qualifies for credit on her own. Ms. Fraudster pays \$500 to her relative, Mr. Borrower, to obtain credit from XYZ Bank under Mr. Borrower's own name. Ms. Fraudster arranges for an inflated appraisal to complete the transaction. When the loan is made, Mr. Borrower gives the loan proceeds check to Ms. Fraudster, who purchases the RE. Since Ms. Fraudster receives the true economic benefit of the loan, she successfully circumvented the lender's lending limit.

In most cases, Ms. Fraudster makes payments on the loan for awhile. However, over time the loan will likely go into default and the lender will eventually be forced to foreclosure. The FI is left with a higher loan-to-value loan than expected, and consequently, higher loss.



APPENDIX D  
Initial Diagnostic Checklist

**INITIAL DIAGNOSTIC CHECKLIST (Optional)**  
**Material provided by LoanCert, Glen Allen, VA**

**Note:** All answers should be yes.

**Initial and Final Standard Application (FNMA Form 1003):**

- Does information match relative to property, income, assets, down payment, and other RE owned?
- Are signatures consistent between the initial and final 1003?
- Is the application dated BEFORE rather than AFTER the date of the appraisal?
- Does the borrower intend to rent the current residence with a documented lease provided and is the lease complete and accurate?
- Are the details of the transaction consistent between the initial and final 1003?
- Is the income level consistent with the type of employment or age of borrower?
- Has the borrower had experience in the area and with the lender?
- Are there no pieces of out-of-state RE listed on the 1003?

**Appraisal:**

- Do comparables bracket the subject time frames?
- Do comparables look fresh or at least not look familiar?
- Are comparables listed in the Multiple Sales Listings?
- Are comparables sold within 6 months?
- Are comparables within 1 mile?
- Are the adjustments less than 25% of comparable values?
- Does the owner of the property match the owner on the title commitment and sales contract?
- Was the appraisal ordered by and for the lender?
- Is the property currently not tenant-occupied when the loan is for purchase money for an owner-occupied transaction?
- Do photos of the subject property match the description? (for example, two-story vs. one-story)
- Is the appraiser from the same county or area as the subject property?

**Credit Report:**

- Is the number of mortgage inquiries limited?
- Is the earliest loan consistent with the borrower's age?
- Are address and employment information consistent with application?

APPENDIX D  
Initial Diagnostic Checklist

- Are Also Known As Names (AKAs) limited?
- Are loan rates different for the various notes?
- Are Hawk Alerts used and limited?
- Does a high-income borrower have a thick credit file, or are a low-income borrower's credit inquiries limited?
- Is the number of accounts in line with the income level?

**Sales Contract:**

- Did all parties execute the contract?
- Does the borrower's signature match other file documents?
- Are realtors absent as participants in the transaction?
- Is the contract dated?
- Does the contract call for earnest money deposits?
- Is an escrow agent holding the earnest money deposit?
- Was the sales contract signed BEFORE all other documents in the file? This assumes the borrower was not pre-qualified.
- Was the realtor commission a normal amount?
- Is the borrower noted as the purchaser of the property?
- Is there only one purchaser on the sales contract when the loan application is for an individual borrower?

**Title Policy/Opinion:**

- Is the owner of the property the same as the owner shown the title commitment?
- Does the owner shown on the commitment match the owner noted on the appraisal?
- Does the seller match the seller on the purchase contract?
- Does the title policy list lien holders that are to be paid? Are these the same as reflected on the HUD-1?
- Does the title commitment require only one deed to be used to finalize the transaction?

**Chain of Title:**

- Are the names the same as only those who have appeared as having had previous interests in the property?
- Has a warranty deed been filed on the property versus a quitclaim deed?
- Have owners had title for long periods of time?
- Have owners been individuals rather than corporations?
- Has there been no gap in the chain of title?

**Asset Verification:**

- Are deposit accounts in the borrower's name only?

APPENDIX D  
Initial Diagnostic Checklist

- Does the address on the account statement match other address information in the file?
- Do account statements show no large or unexplained deposits?
- Was verification of down payment used versus an alternate document such as an FI statement?
- Is the borrower young or low-to-moderate income and not have asset balances that are large or out of place?
- Were the deposit accounts not opened recently?
- Do account statements indicate normal balances with no NSF's during the statement cycle?
- Do account statements indicate deposits of employment income as evidenced by file?

**Income/Employment Verification:**

- Does address information on W-2 forms, paystubs, or tax returns match address information given on the 1003?
- Are paystubs computer generated?
- Is the employer's address noted on the verification of employment (VOE)?
- For verbal VOEs, was the employer's phone number independently verified using 411, a drive-by visit, or another similar way?
- Is the employer within a logical distance of the subject property?
- Are wages noted in uneven dollar amounts?
- Is the federal employment identification number different from the state number in a state that has state taxes?
- Is the W-2 form provided for verification **not** the copy that should be filed with taxes?
- Are FICA withholdings accurate?
- Do numbers appear to be in the same fonts?

**HUD-1 Settlement Statement:**

- Did all parties sign the HUD-1?
- Is the borrower's signature consistent with other documents in the file?
- Are there payoffs from the seller's funds to entities or persons only noted as lien holders on the Title Commitment?
- Does the file contain only one HUD-1?

APPENDIX E  
Criminal Statutes

The following is a partial list of federal criminal statutes that may be violated by perpetrators of third party mortgage fraud. This list is not exhaustive. The final decision as to whether a participant in third party mortgage fraud will be prosecuted and under which statute a participant would be charged with rests with the U.S. Department of Justice. Additionally, such fraud may violate state laws.

Statute	Brief Description	Description
18 U.S.C. § 1005	False Entries	Prohibits false entries in any book, report, or statement of an insured institution, with intent to injure or defraud such institution or any other company, or to deceive any officer of such institution or its regulators.  Also prohibits unauthorized making, drawing, issuing, or assigning of any certificate of deposit, draft, order, note, or mortgage.  Additionally, prohibits the participation, sharing or receipt of (directly or indirectly) any money, profit, property, or benefits through any transaction, loan, commission, contract, or any other act of any insured FI with intent to defraud the United States or any agency, or any insured FI.
18 U.S.C. § 1014	False Statements on a Loan or Credit Application	Prohibits oral or written false statements or misrepresentations made knowingly on a loan or credit application to an insured institution, i.e., willful over-valuing of land, property, securities or other assets or understatement of liabilities.
18 U.S.C. § 1028	Unlawful use of Identification	Prohibits the knowing use, without lawful authority, of a means of identification, such as an individual's social security number or date of birth, of another person with the intent to commit a crime.
18 U.S.C. § 1029	Fraud and Related Activity in Connection with Access Devices	Prohibits the production, use, and trafficking in counterfeit access devices (credit or debit cards), and the use of unauthorized access devices aggregating \$1,000 or more during a one-year period, done knowingly and with intent to defraud.
18 U.S.C. § 1030	Computer Fraud	Prohibits knowingly accessing a computer without authorization or having accessed a computer with authorization, using it for

APPENDIX E  
Criminal Statutes

Statute	Brief Description	Description
		unauthorized purposes, e.g., obtaining information contained in records of FIs.
18 U.S.C. § 1341	Mail Fraud	Prohibits use of the mail system in the furtherance of a fraudulent scheme.
18 U.S.C. § 1343	Wire Fraud	Prohibits any scheme or artifice to defraud or to obtain property or money through use of wire, telephone, radio or television transmissions in interstate commerce.
18 U.S.C. § 1344	Bank Fraud	Prohibits the use of a scheme or artifice to defraud an insured institution or to obtain, through misrepresentations, any of the monies, funds, credits, assets, securities, or other property owned by, or under the control of, the institution.
18 U.S.C. § 1519	Destruction, Alteration or Falsification of Records	Prohibits the knowing destruction, mutilation, concealment, alteration or falsification of records with intent to impede, obstruct, or influence the investigation of any matter within the jurisdiction of any department or agency of the United States.
18 U.S.C. §§ 1951-1961	Racketeer Influenced and Corrupt Organizations (RICO)	Commonly referred to as "RICO" statutes. Prohibits investments in any enterprise affecting interstate commerce if the funds are derived from a "pattern of racketeering activity". These activities include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, embezzlement from pension funds, wire fraud, obstruction of criminal investigations, and fraud in the sale of securities.
18 U.S.C. § 1956	Laundering of Monetary Instruments	A RICO statute that makes it illegal to conduct or attempt to conduct a financial transaction knowing that the property involved in the transaction represents the proceeds of some form of illegal activity. There must be intent to promote the carrying on of specified unlawful activity or knowledge that the transaction is designed in whole or in part to conceal or disguise the nature, location, source, ownership, or control of the proceeds of unlawful activity or to avoid a transaction-reporting requirement under state or federal law.

APPENDIX E  
Criminal Statutes

Statute	Brief Description	Description
18 U.S.C. § 1957	Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activity	This RICO provision makes it illegal to engage or attempt to engage in a monetary transaction including deposits, withdrawals, transfers, or exchanges in property constituting, or derived from, proceeds obtained from a criminal offense knowing that it is criminally derived property and has a value of over \$10,000.
18 U.S.C. § 371	Conspiracy to Defraud	Prohibits a conspiracy of two or more persons to commit a federal offense or to defraud the United States or any agency.
18 U.S.C. § 1342	Fictitious Name or Address	Prohibits the use of a false, assumed or fictitious name, address or title for the furtherance of a fraudulent scheme, which is carried out by means of the postal service.
18 U.S.C. § 2314	Transportation of Stolen Goods, Securities, etc.	Prohibits transportation of stolen goods, securities, moneys or falsely made, forged, altered or counterfeited securities in interstate commerce. Obtaining money from an FI on either a forged check of any amount or a fraudulently obtained check of \$5,000 or more, which is drawn on an FI in another state, comes under this section since it is transported in interstate commerce.
18 U.S.C. § 1010	Department of Housing and Urban Development and Federal Housing Administration transactions	Prohibits the making, or publishing any statement, knowing the same to be false, or altering, forging, or counterfeiting any instrument, paper, or document, or willfully overvaluing any security, asset, or income, for the purpose of obtaining any loan, with the intent that such loan will be offered to the Department of Housing and Urban Development for insurance, or otherwise attempting to influence in any way the action of the Department.
42 U.S.C. § 408	Fraud in connection with Social Security identification documents	Prohibits falsely using a number as a legitimate social security account number, with intent to deceive and for the purpose of obtaining anything of value from any person, or for any other purpose.

APPENDIX F  
References and Resources

**Resources for Combating Mortgage Fraud:**

AARP (American Association of Retired Persons)

email: [member@aarp.org](mailto:member@aarp.org);

[www.aarp.org/indexes/money.html#consumer](http://www.aarp.org/indexes/money.html#consumer)

American Land Title Association, [www.alta.org](http://www.alta.org)

Appraisers Licenses, [www.asc.gov](http://www.asc.gov) (Appraisal Subcommittee of the Federal Financial Institutions Examination Council)

Better Business Bureau [www.bbb.org/library/first.asp](http://www.bbb.org/library/first.asp)

Department of Justice - Identity Theft & Fraud; Mortgage Scams:

[www.usdoj.gov/fraud.htm](http://www.usdoj.gov/fraud.htm)

Financial Crimes Enforcement Network (FinCEN), SAR information;  
Financial institution hotline (terrorist activity); [www.fincen.gov](http://www.fincen.gov)

Florida Department of Banking & Finance, Office of Comptroller  
(800)848-2792; [www.dbf.state.fl.us](http://www.dbf.state.fl.us);

Florida Abuse Hotline 800-962-2873

GAO Reports - Money Laundering; [www.gao.gov](http://www.gao.gov)

HUD Hotline (800)347-3735; fax (202)708-4829; [www.hud.gov](http://www.hud.gov)

Internal Revenue Service - Tax Fraud Hotline, (800)829-0433

[www.irs.gov](http://www.irs.gov); Tax Fraud

Local State Attorney General's Offices - directory of all 50 states'  
web sites: [www.carbuyingtips.com](http://www.carbuyingtips.com)

Mortgage Bankers Association - Predatory Lending Resource  
Center & Mortgage Fraud Alert,  
[www.mbaa.org/alerts/index.html](http://www.mbaa.org/alerts/index.html)

Mortgage Bankers Association - Mortgage Fraud Subcommittee  
[www.mbaa.org](http://www.mbaa.org)

National White Collar Crime Center - Identity Theft [www.cybercrime.org](http://www.cybercrime.org)

Office of Comptroller of the Currency - Issuances, Bulletins, 2001, 3rd  
Party Relationships [www.occ.treas.gov](http://www.occ.treas.gov)



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References and Resources

Office of Foreign Assets Control; Regulations by Industry; SDN  
(Specially Designated Nationals) & Blocked Persons  
[www.ustreas.gov/offices/eotffc/ofac](http://www.ustreas.gov/offices/eotffc/ofac)

Predatory Mortgage Reform,  
[www.consumerlaw.org/initiatives/predatory\\_mortgage/](http://www.consumerlaw.org/initiatives/predatory_mortgage/)

Security Mortgage Fraud  
[www.consumerlaw.org/consumer/secmort.html](http://www.consumerlaw.org/consumer/secmort.html)

U.S. Public Records [www.searchsystems.net](http://www.searchsystems.net)

Additional Topics

Federal Trade Commission - Consumers; Identity Theft [www.ftc.gov](http://www.ftc.gov)

FBI - Reports & Publications; Financial Fraud & Failure Reports  
[www.fbi.gov](http://www.fbi.gov)

APPENDIX G  
Interagency Appraisal and Evaluation Functions

**Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
Office of Thrift Supervision  
National Credit Union Administration**

**INDEPENDENT APPRAISAL AND EVALUATION FUNCTIONS**

October 27, 2003

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (the agencies) are jointly issuing this statement to address concerns identified during examinations about the independence of the collateral valuation process. This statement applies to all real estate-related financial transactions originated or purchased by a regulated institution for its own portfolio or as assets held for sale. It provides further clarification of, and should be reviewed in conjunction with, the agencies' appraisal and real estate lending regulations<sup>1</sup> and the *Interagency Appraisal and Evaluation Guidelines* (Guidelines).<sup>2</sup>

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (program) for all of its lending functions. The real estate lending functions include commercial real estate mortgage departments, capital market groups, and asset securitization and sales units. These independence concerns include the risk that improperly prepared appraisals may undermine the integrity of credit underwriting processes. More broadly, an institution's lending functions should not have undue influence that might compromise the program's independence.

**Selecting Individuals to Perform Appraisals or Evaluations**

The Guidelines establish minimum standards for an effective program, including standards for selecting individuals who may perform

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<sup>1</sup> OCC: 12 CFR 34, subparts C and D; FRB: 12 CFR 208 subpart E and appendix C, and 12 CFR 225 subpart G; FDIC: 12 CFR 323 and 12 CFR Part 365; OTS: 12 CFR Part 564, and 12 CFR 560.100, and 12 CFR 560.101; and NCUA: 12 CFR Part 722.5.

<sup>2</sup> The interagency guidelines may be found in: *Comptroller's Handbook for Commercial Real Estate and Construction Lending for OCC*; SR letter 94-55 for FRB; FIL-74-94 for FDIC; and Thrift Bulletin 55a for OTS. NCUA was not a party to the guidelines; however, the NCUA applies the content to credit unions, when applicable.

## APPENDIX G

### Interagency Appraisal and Evaluation Functions

appraisals or evaluations. Among other considerations, the selection criteria must provide for the independence of the individual performing the appraisal or evaluation. That is, the individual has neither a direct nor indirect, interest, financial or otherwise, in the property or transaction. Institutions also need to ensure that the individual selected is competent to perform the assignment. Consideration should be given to the individual's qualifications, experience, and educational background. Selection occurs when, based on an oral or written agreement, the individual accepts the assignment to appraise or evaluate a particular property. Moreover, appraisal or evaluation development work should not commence until the institution finalizes the selection process.

The agencies' appraisal regulations address appraiser independence and require that an institution, or its agent, directly engage the appraiser. The only exception to this requirement is that an institution may use an appraisal prepared for another financial services institution, provided that the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable. Independence is compromised when an institution uses an appraiser who is recommended by the borrower or allows the borrower to select the appraiser from the institution's list of approved appraisers.

It is also important to ensure that the program is safeguarded from internal influence and interference from an institution's loan production staff. Individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services. The agencies recognize that it may not be possible or practical for small institutions to separate the collateral valuation and loan production processes. To ensure independence, loan officials, officers or directors with the responsibility for ordering appraisals and evaluations should not have sole approval authority for granting the loan request.

When selecting and engaging individuals, an institution needs to identify the assignment and order the appropriate appraisal or evaluation, as discussed in the Guidelines. To foster control and accountability, the agencies encourage an institution to use written engagement letters when ordering appraisals, especially for large, complex, or out-of-area commercial real estate properties. An institution should include a copy of the written engagement letter in the permanent loan file. An appraiser may also incorporate an engagement letter in the appraisal report. The engagement letter confirms that the assignment was made in a manner that complies with

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### Interagency Appraisal and Evaluation Functions

the institution's procedures and the agencies; regulations and Guidelines.

#### **Appraisal and Evaluation Compliance Reviews**

An institution's appraisal and evaluation program must maintain effective internal controls that promote compliance with program standards and the agencies' appraisal regulation and Guidelines. Internal controls should, among other criteria, confirm that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan production processes. The institution's standards for the depth of such reviews should reflect the risk of the transaction and the process through which the appraisal or evaluation is obtained. An institution should establish more in depth review procedures for appraisals of large complex or out-of-area commercial real estate credits and for those appraisals and evaluations that are ordered by agents of the institution, such as loan brokers or another financial services institution.

Even in small institutions when absolute lines of independence cannot be achieved, effective internal controls should be implemented to ensure that no single person has sole authority to render credit decisions involving loans on which they ordered or reviewed the appraisal or evaluation. Further, lending officials, officers, or directors should abstain from any vote or approval involving loans for which they performed the appraisal or evaluation.

#### **Supervisory Approach**

Examiners will review an institution's standards of independence, taking into consideration the size of the institution and the nature and complexity of its real estate-related activities. Examiners will consider whether policies and procedures are comprehensive and applied uniformly to all units engaging in federally related transactions.

If an institution suspects that a licensed or certified appraiser is violating applicable laws or USPAP, or is otherwise engaging in other unethical or unprofessional conduct, the institution should make referrals directly to the appropriate state appraiser regulatory authorities. Examiners finding evidence of unethical or unprofessional conduct, including improperly prepared appraisals or evaluations and readdressed appraisals, should forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state appraiser regulatory authority, as necessary. Institutions and institution-affiliated parties, including lenders, staff and fee appraisers, are reminded that they could be subject to

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enforcement actions, which include removal/prohibition orders, cease and desist orders, and civil money penalties, for violations of the agencies; appraisal and real estate lending regulations.