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The Top 50 Best Practices for Preventing Mortgage Fraud

How does your credit union score on risk mitigation and fraud detection?

By Stephen Coakley

Defaults and real estate owned are an unfortunate aspect of any mortgage lending business. Unforeseen circumstances – despite sound underwriting – can turn even long time members into delinquent borrowers. In today's economic environment, we are finding this even more so to be true. But how does a credit union protect itself and its members from the more insidious losses – both financial and in terms of a firm's good name – due to mortgage fraud? It's an important question.

As long as there have been mortgages, there has been mortgage fraud. But FBI statistics and recent media reports indicate fraud is on the rise. Makes sense – when times are tough, fraud becomes even more prevalent. There are more people willing to commit fraud and there is a larger pool of potential victims – think short sale and foreclosure rescue scams – of circumstances.

To a large extent, when real estate values are rising, mortgage fraud isn't always a high priority in the lending community. In good times, best practices and quality control are often viewed as just slowing down processing or, worse yet, killing deals - a drag on the bottom line. Real estate appreciation, it has been said, is the deodorant for the stink of losses. But with the prospects of strong appreciation rather dim for the foreseeable future, mitigating fraud is not a short term trend. It's a necessity that is here to stay.



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Conventional wisdom might also say that credit unions are less vulnerable to mortgage fraud because they lend to members, typically locally, and often directly – that is without third parties. All true. However, as history has shown, members can be fraudsters or victims; credit union employees can commit fraud, and reliance on third parties – especially as a way to meet a surge in demand – provides plenty of risks. A surge in applications creates even more risks. Of course, a surge is underway now with record low interest rates. Just last month, Navy Federal Credit Union in Vienna, Va., announced it expected to close a billion dollars worth of mortgages between July and August. It originated a record \$6.2 billion last year and expects to beat its record this year (<http://www.navyfederal.org/about/newsrooms.html>).

With a surge in applications and the credit union industry grabbing a larger share of the mortgage market in general, credit unions are assuming even more mortgage related risk – especially if loans are held in portfolio. With a greater market share, the industry becomes a larger target. A perceived lack of sophistication or diligence at a credit union is a welcome sign for professional fraudsters. The irony is that fraud detection doesn't require sophistication. It's simple stuff. But it must be ingrained into origination and servicing operations and cannot be ignored because of time pressures, surging volumes or lack of staffing.

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focus on best practices and red flags in order to mitigate fraud. Training can't just be about sales and product lines. The Federal Financial Institutions Examination Council updated "The Detection and Deterrence of Mortgage Fraud Against Financial Institutions: A White Paper" in February of this year. The report includes an extensive list of best practices. We've culled the list down significantly to the top 50 most important tools in avoiding and identifying fraud, and have added a few tips where we believe there is room for improvement. We've also reorganized them – not based on fraud type which can be clunky in terms of evaluation or implementation – but on how loans are processed, underwritten and closed. Take the test. How many of these best practices has your credit union implemented?

Borrower Identification

- Know your customer! Obtain valid government identification at the time of application, compare with a second form of picture ID (e.g., passport, picture credit card, work ID badge, etc.)
- Review for legitimate format on social security cards: 3-2-4 format in the center of the card (XXX-XX-XXXX).
- Conform with the Fair Credit Reporting Act (FCRA) and Fair and Accurate Credit Transactions Act of 2003 (FACTA) requiring institutions to have policies and procedures in place to detect, prevent, and mitigate identity theft.

Processing

- Use fraud detection software to assist in verification of identity of borrower(s).
- Verify borrower(s) name and SSN with the Social Security Administration, including death master index, review SSN to see if year of issuance is in line with borrower's date of birth.
- Make direct inquiries to the borrower and creditors to obtain an explanation of unusual or inconsistent information.
- Use credit reporting agency fraud alerts when ordering credit reports.

- Compare employment and residence history on the credit report to that listed on the application.
- Review credit report for large numbers of recently opened accounts and conflicting information with the application, and for recent credit deficiencies, mortgage defaults, excessive number of mortgage loan inquiries, payment history delinquencies, AKAs and alternate social security numbers.
- Use fraud detection software for listings of owned real estate to find undisclosed properties owned by the applicant.
- Verify borrower employment and income.

Tip: Require that all borrowers provide at least two paystubs, even if guidelines require one paystub. Discrepancies in paystub font type and size changes, lack of company name, unfamiliar logos, unknown payroll company, format, year-to-date earnings cannot be detected if only one paystub is provided.

Tip: Written Verification of Employment forms can be very useful, and are a necessity for verifying overtime, bonus, and commission income, but should never be the sole source of past earnings information. W-2s should also be included in the file, and any discrepancy between previous earnings shown on the written Verification of Employment and the W-2 provided by the borrower should be addressed.

- Verify employment by researching the location and phone number of the employer.
- Ensure the address information on W-2 forms and tax returns matches data provided on the application.
- Determine if the borrower's work location is within a reasonable distance from subject property.



- Compare employment against the credit report, bank statements (for direct payroll deposits), and tax returns.
- Verify social security and Medicare tax withholding is correct on W-2— generally 6.2 percent for social security and 1.45 percent for Medicare.
- For self-employed borrowers, contact appropriate state regulator to determine validity of business, compare information about the business with tax returns.
- Verify that rental agreements are bona fide (e.g., contact parties to agreement).
- Compare income claimed on tax returns and amended tax returns against other file documentation such as W2s, paystubs, application, and credit report.
- Require borrowers to sign and date Form 4506-T Request for Transcript of Tax Return.

Tip: Tax transcripts should be reviewed for all borrowers, for a minimum of one year. Careful attention should be paid to Schedule A deductions, including mortgage interest deductions for borrowers who have not disclosed ownership of

property, and unreimbursed business expenses, even for borrowers in professions where you would not normally expect these type of expenses.

- Verify the earnest money deposit and funds to close (seasoned vs. recent deposits).
- Execute a direct verification of deposit to the bank.
 - Tip:** Eliminate the use of Verification of Deposit forms as the sole documentation for verifying asset accounts. At a minimum, require one bank statement to accompany the VOD. This will allow verification that your borrowers were not added to the account solely to show sufficient funds for closing, and eliminate the use of “rented” assets.
- Copy the original bank statements as well as paystubs and W-2s – avoid accepting copies made by the borrower/broker.
- Verify the legitimacy of asset accounts held outside of the credit union by researching their location and phone number. For asset accounts held by the credit union, re-verification of assets should also be performed.
- Obtain a complete, fully executed copy of the purchase contract and all addenda and ensure that the terms of the purchase contract match the mortgage application and appraisal.
- Establish appraisal management practices that detail the order and review processes, including an approved appraiser list.

Underwriting

- Ensure borrower signature is consistent on the loan application, sales contract, and other file documents.
- Compare income claimed against other file documentation such as W2s, paystubs, application and credit report.
- For investment properties, evaluate the reasonableness of rent cash flows and determine the borrower’s ability to carry the debt without a tenant.
- Require notarized documents, if necessary, and then

confirm the notary is authorized by the state.

- Review the title commitment for evidence of property flipping. Compare to appraiser’s three-year sales history, and verify seller on sales contract.
- Determine if the sales transaction is arm’s length; identify common surnames, telephone numbers, addresses, etc.
- Determine length of ownership requirements prior to cash-out refinance transactions being granted (reference application, appraisal and title commitment).
- Periodically conduct physical verification of the location and condition of selected subject properties and comparables.
- Review marketing materials associated with the newly constructed developments (printed or electronic).
- Use website www.ASC.gov to determine if there are any enforcement actions against appraisers on the National Registry, which list appraisers who are eligible to perform appraisals in connection with federally related transactions.
- Provide fraud updates/alerts to employees.
- Review patterns on declined loans, such as individual social security number, appraiser, real estate agent, loan officer and broker.

Pre-Closing or Pre-Funding Quality Assurance

- Establish specific employment verification procedures in the pre-funding quality assurance program and use pre-funding reviews to detect any inconsistencies within the transaction. A complete pre-closing or pre-funding review should include determining if any straw borrower red flag indicators are present.
- Ensure earnest money deposits on contract match HUD-1.

Closing

- Review both the buyer and seller sides of the HUD-1 prior to closing for unusual entries or amounts, disbursements of funds to non-lien holders.
- Compare payouts from seller’s funds to lien holders

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on the title commitment.

- Compare signatures on the HUD-1 to signatures throughout the file.
- Verify previous lien pay-off from the original lender.
- Receive a complete closing package prior to funding.
- Obtain attestation from seller and buyer that there are no undisclosed terms.
- If power of attorney is to be used, confirm with the party that the POA was authorized, and why the POA is necessary.

Post Closing

- Employ a post-closing review to identify any inconsistencies as part of a quality control plan.
- Compare elements of the final title policy to the original title commitment and other closing documents (e.g., HUD-1).

Scoring

If your credit union is performing less than half of these best practices, your organization is at significant risk of mortgage fraud. If your organization is performing 40 or more of these best practices, you have clearly taken steps to mitigate fraud. For all lenders, there is room for improvement.

Red flags are an important training tool, as well. “The Detection and Deterrence of Mortgage Fraud Against Financial Institutions: A White Paper” contains some 250 red flags – far too many to list here. The entire publication can be found online at <http://www.ffiec.gov/press/pr021610.htm>. If there is an overarching mantra of these best practices, it’s *trust, but verify*.

Whenever reasonable and feasible, independently verify the information provided by the member or vendor from another

independent source. When there are discrepancies, investigate.

Finally, know who you are doing business with – clearly an advantage for credit unions and its members. But this rule of thumb must include third parties. Case in point: In October of last year, in “Operation Bad Deeds,” the FBI busted a mortgage scheme in New York. In all, 41 defendants were charged with fraudulently obtaining \$64 million in residential mortgages. Their ranks included six lawyers, seven loan officers, three brokers, one accountant and an appraiser (<http://www.fbi.gov/congress/congress09/perkins120909.html>). It is worth repeating: Know who you are doing business with and recertify them occasionally.

When all is said and done, the entire industry must go back to basics. Credit unions never really left those basics, and now have a built-in competitive advantage in today’s markets.



Stephen R. Coakley founded Horizon in July of 1994 and today serves as Principal and Vice-President. He focuses on Horizon’ leadership, vision, corporate culture, strategic and financial planning, and business while ensuring the company’s adherence to the foundational principles of honesty, integrity, professionalism and hard work.

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