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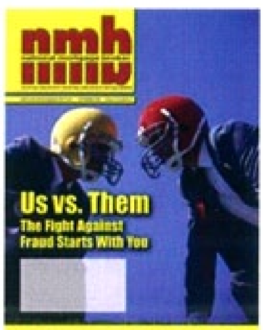

September 2006 issue:

This Month's Cover Story

Us vs. Them: The Fight Against Fraud Starts With You

by Kathy Coon

We've all heard the grim statistics: mortgage fraud cost this country more than $1 billion in reported losses in 2005. Mortgage fraud affects more than just a lender's bottom line, however. Taken to extremes, fraud can destroy entire neighborhoods when foreclosures take other property values down with them, or increase mortgage costs for consumers and mortgage brokers alike.

Fraud isn't just a mortgage broker or an appraiser problem: at every stage of the lending process, everyone can take simple steps to prevent fraud, catch it and report it or mitigate its impact.

Crooks, Cheats & Well-Intentioned Truth-Stretchers

According to the FBI, the most common types of mortgage fraud, in order of frequency, are:

1. Appraisal fraud, in which the appraiser inflates or otherwise fakes a property value. This ranges from obviously false values to nudging the value up a few thousand in response to lender or mortgage broker pressure to make the deal.

2. Property flipping, in which a property is bought and quickly "flipped" to a new buyer at a price not supported by its actual value. An appraiser also plays a role in this scheme by inflating the valuation.

3. "Straw buyers" who are different than the person reported as providing the funds for the purchase.

4. Identity theft in which a person's identity – Social Security number, credit history, etc.--is used illegally by a third party to secure a mortgage loan on a property.

Straw buyers and identity thieves are crooks, just like any run-of-the-mill burglar. In fact, on a national level, law enforcement is starting to pay more attention to organized crime groups--gangs of street thugs and drug dealers--who have started mortgage fraud schemes because they can be even more lucrative, and considerably less risky, than dealing crack. The most recent gang report in Chicago mentioned mortgage fraud as a growing concern there.

Property flippers are cheats. Reselling a home at a much higher price is not technically illegal and may not be caught when values are rising and the buyers don't default. However, this doesn't mean it's not wrong. The appraiser has still committed fraud by inflating the property's valuation even if no loss results. When appraisers, sellers and mortgage brokers work together to artificially inflate the value and take advantage of an unsuspecting buyer, that's fraud.

Identity thieves, straw buyers and property flippers get a lot of attention in the mainstream and industry press. The stories make compelling crime drama, with bad guys and victims.

But appraisal fraud is far more costly, far more pervasive and far harder to catch. The organized schemes get more attention, but in reality, some appraisers commit fraud every day, and may not even realize they're doing it. They are the well-intentioned truth-stretchers.

Appraisers often feel pressure from lenders and mortgage brokers to hit a higher value than what their experience tells them the property is actually worth. Lenders and brokers may not ask them to falsify a value outright, but the appraiser might fear losing the customer's business. When I worked as a fee appraiser, I felt that same pressure, and I often lost business because I refused to hit a certain number.

Losses from inflating values tend to go unnoticed because they aren't shocking losses on one house--they are small losses on many, many houses. On a case-by-case basis, the loss is not high enough for law enforcement to notice or even for the lender to pursue monetarily. They just write the loss off and everything continues; nothing may even happen to the appraiser. He or she may be removed from the appraisal list of that particular company or mortgage broker, but continue to operate on other lists.

In all four scenarios, fraud can stop at the appraisal. Without the inflated appraisal report, fraudulent loans don't get funded. By detecting these bad apples before the loan goes through, lenders can save millions each year, and brokers can save their reputations.

What You Can Do: Look for Red Flags
Responsible mortgage brokers and appraisers know that appraisal fraud by some unscrupulous members of our profession stain all of us. The pressure appraisers feel from lenders is real, but rather than complain about it, everybody needs to clean up their collective house. Appraisers, mortgage brokers and lenders all need to take responsibility to encourage the highest standards of professional ethics.

The National Association of Mortgage Brokers has done this consistently through its rigorous certification program and by providing a link on its Web site to the FBI's white-collar crimes division, directing its members and consumers to report fraud or suspicious practices.
But fraud will still happen. What can catch it? The appraisal report itself. Most appraisal fraud cases share a common characteristic--the report the appraiser submitted is full of red flags that an underwriter should be trained to catch. The report may comply with federal regulations in every way, but if it contains any of the following, it warrants further review:

• Photos that don't match the property description
• Maps that aren't consistent with the data in the appraisal report
• Large age and effective age variances not supported
• Sales or financing concessions not reported; not adjusted properly
• Improper selection of comparables, either located outside the subject's market area, or not comparable in key elements such as room count, square footage,

design, appeal, etc.
• Adjustments to comparables not explained or supported
• History omitted or not analyzed (violation of USPAP – Uniform Standards of Professional Appraisal Practice)
• Inconsistent information throughout the appraisal report

Most underwriters don't have the luxury of time to closely scrutinize each appraisal report with a detailed checklist--they feel pressure, too. Technology can help. At FNC, we developed an automated appraisal review system that can be customized with these rules and checked automatically. The problem reports are flagged for human review, speeding the process and making it much harder for problem reports to slip through the cracks.

Still, mortgage brokers don't train underwriters or reviewers; they try to make good loans. Still, brokers must be vigilant about the appraisers they do business with and mortgage brokers should also consider getting some training in appraisal issues to gain understanding of the process and know why some reports are questioned.

More and more, large lenders are turning to technology to track vendor and mortgage broker performance. Working with a bad appraiser who leads to lender losses means the broker may lose business as well.

How can you protect your professional reputation? Know the company you're keeping. Choose appraisers carefully, check their backgrounds, and keep accurate records on their performance with regard to quality issues.

Do not form a friendly bond with an appraiser; keep the relationship professional. Also, don't use only one appraiser for every deal. Rotate and keep your options open. Never try to influence or allow anyone you work with to influence the appraisal process.

Lobby for mandatory state licensing programs that include thorough background checks and educational requirements for mortgage brokers. Appraisers moved in this direction several years ago. Such measures raise the status of your profession and make you more invaluable to lenders.

Reputable appraisers and mortgage brokers share a common interest-- protecting our profession from those who would denigrate it by committing fraud. New laws or federal regulations aren't enough. Fraud is already illegal, after all.

By policing ourselves, watching for the red flags of fraud, reporting what we know and standing up for the highest standards, we can stop fraud before the losses start.

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