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“Please Ma’am, Just the M-FACTS (Mortgage Fraud, Abuse, Collusion, Theft, and Schemes)”

Market losses continue to skyrocket with increasing levels of criminal sophistication -- Part 1

By Mark P. Dangelo



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About Mark Dangelo

Specializing in the end-to-end **acceleration of product and service life-cycles**, financial industry specialist Mark P. Dangelo has led very large global organizations, while improving time-to-market, market positioning, customer segmentation, and bottom-line profitability. Mark, as a recognized mortgage and real estate industry authority, has assisted organizations with and published on market analysis, business process compartmentalization and outsourcing, front-end and servicing operational efficiencies, and customer data integrations.

Mark has provided hands-on leadership for nearly 100 clients over a period of 20 years encompassing members of the Fortune 50 and organizations within the Russell 3000. Mark also writes monthly for the Mortgage Bankers' Association MBA Tech NewsLink, hosts a weekly Podcast show "**Insights and Lessons from Business Leaders**," and is the frequently quoted author of the **Innovative Relevance®** series of management books.

With the ongoing news being decidedly negative surrounding home sales, valuations, inventory, consumer confidence, and credit quality, those of us within the real estate and mortgage industries have to be asking, "What's next and where is the new pain point?"

As the residential mortgage market bounces between \$2.5 and \$3 trillion dollars annually, criminals and unethical professionals have expanded their dishonest activities resulting in a year-over loss increase of over 250%. What's astounding in addition to confusing when trying to mitigate the risks and exposures dreamed up by increasingly complex illegal efforts is the lack of consistency and comprehensive information surrounding mortgage fraud or M-FACTS. Numerous articles and market authorities refer to the same sources, but their conclusions and analysis are many times incompatible.

The informal questions posed to me from mortgage professionals during the creation of this article indicate the breadth of this disarray. Some notable responses included:

- "So how can we frame the discussion and apply the needed resources holistically to organizational initiatives surrounding fraud mitigation rather than just dealing with issues and events as 'one-offs'?"
- "What are the lessons learned that need to be applied for the attainment of an iterative solution set which readily adapts to the criminal's on-going chess game?"
- "Besides, if we meet our obligations to the letter of the regulatory law, isn't that enough? Why are we being held to a higher standard of operation (i.e., the "spirit of the law") when others are committing the crimes?" (in reference to a new State of Georgia law holding lenders criminally liable for fraudulent loans)
- "Why should we be accountable for the actions of our partners or third-party agents when we lack any corroborating data or ability to influence their operating parameters?"
- "We just spent large sums of corporate dollars making sure we adhered to federal, state, and local governance and reporting laws -- so why didn't we foresee this coming? Why do we approach our controls as non-leveraged silos of enforcement and protection?"

In spite of regulations and laws, "Criminals and scammers are seeking organizations that lack integrated customer and third-party information, operate within organizational silos, and have weak processes or hand-offs in their continual efforts to profit from the borrower and lender," says Jeffery Taylor, CEO of Digital Risk, a company specializing in mortgage risk mitigation. "Without a systemic approach to risk mitigation that integrates tools, processes, and data, organizations will continually be reacting to schemes rather than eliminating exposures and losses." All this begs the question of how the growing dependence on BPO and IT outsourcing also impacts operational integration and costs when combating M-FACTS?

The Current Situation

In 2005, the FBI noted that the number of mortgage fraud cases rose from 3,088 in 1999 to 21,994 in 2005 resulting in an annualized loss last year of over \$1 billion (based on SAR's, suspicious activity reports, required by federally insured financial organizations). However, other

Key Article Highlights:

- If not combated with new methods and techniques, mortgage fraud could top tens of billions of dollars in reported losses by the next decade.
- Without robust enterprise integration of the threats, workflows, and data interrelationships, our organizations can only react to the growing iterative and adaptive criminal behaviors.
- The use of the M-FACTS framework for fraud response creates an operational improvement model that is both actionable and designed for stepwise implementation.

unsubstantiated industry estimates put the real and often unreported losses at \$40 to \$55 billion annually or roughly 1.5% of the current mortgage market.

Moreover, Fannie Mae released in December 2005¹, a report driven by significant post-origination data analysis that brought into sharp focus the widespread industry abuses and “misrepresentations:”

- Occupancy abuse or falsification - 15%
- Inflated valuation or property appraisal - 18%
- Credit history, liability, and identity deception - 21%, and
- Income inflation or employment distortion - 25%

So how can we assimilate or internalize all these numbers and the potential size of the industry and consumer losses? Often times we tune out the size of the numbers because we have a hard time relating to the magnitude of a “billion dollars here or there.” We get immune to the real threats to our livelihood and their impacts to our customers. Being a third generation immigrant, I remember my grandfather and his “trading” philosophy of business where we created relative benchmarks for goods and services that we tied to delivery of an item such as a tractor, a barn, livestock, or even payment for crops.

1. The volume of cargo and trade entering the US in shipping containers has projections that range from \$750 billion to \$1 trillion per year or roughly 1/3 of the annual residential mortgage originations.
2. As of June 2006, the Federal Reserve reports that \$2.2 trillion is outstanding for both revolving and non-revolving consumer credit increasing at 5.7% annually.
3. The losses suffered by record companies due to illegal downloading and file sharing has been estimated at \$4 billion by industry associations or four times that of reported mortgage losses.
4. The popular Apple iPod generated quarterly revenue of approximately \$1.5 billion during Q2 2006.
5. The total of white collar crime in the United States in 2002 was estimated to be over \$400 billion².

There are published predictions that thrust outstanding loans for the residential lending market in excess of \$20 trillion by 2020 and assuming a conservative annual growth rate for M-FACTS of 25%, the market for unlawful activity might surpass \$25 billion (reported). There is currently a very small minority that believes this number could skyrocket to losses exceeding hundreds of billions if the market returns to its above average growth over the next decade.

“Business practices have been traditionally segregated by country of operation and along cultural lines when it comes to determining acceptable credit standards and lending policies,” says Lester Dominick, President of MortgageFlex Systems, Inc. “A key challenge for lenders today is the globalization, uniqueness, and sophistication of ‘imported’ crimes and schemes that are being perpetrated.”

At a personal level, I knew the market was ripe for abuse when just before Thanksgiving in 2005 when I was in Chicago for a client interview and taking a taxi to a downtown hotel. My driver, a pleasant and well-dressed young man, was inquiring about the purpose of my business trip and if I would be seeking housing or real estate in the city. Curious, I asked why. He showed me that he was a “licensed” real estate agent for one of the country’s largest corporations and offered to get me financing regardless of my credit history. He said, driving taxis was a good method to find

¹ “Focus On...Preventing, Detecting & Reporting Mortgage Fraud,” Fannie Mae Newsletter, December 2005

² Association of Certified Fraud Examiners’, 2002. It should be noted that official government statistics are not available due to the lack of agreement of what constitutes “white collar crime.”

new out-of-town buyers early in their search cycle, and it was secondary to his real job of closing real estate transactions. For me, it created a chill up the spine as I wondered how many people saw the corporate logo on the business card and were lured into disclosing their home financing needs. Needless to say, I paid the fare in cash.

What are M-FACTS?

So why create a distinction from the generic term of “fraud?” The simple answer is that there are diverse segments within the end-result of committing fraud against a buyer, lender, or GSE. As a result, if we are to eliminate, mitigate, or in general define controls for avoidance, there needs to be a clear understanding of the nuances involved.

Fraud: This is the most common unlawful activity framed and discussed in popular media - it is a generic term covering a multitude of crimes. It is associated with “for profit” or “for property” schemes in an effort to gain benefit from the borrower or lending organization utilizing actions or transactions that are illegally defined within statutes and industry guidelines.

Abuse: Traditionally associated with prohibited or unethical activities of industry insiders such as brokers, real estate agents, appraisers, and lending officers. Abuse, while often times illegal, deals with the falsification of documents, inflation of property values, and by-passing of internal controls designed to control credit quality, lending standards, and discriminatory practices (e.g., targeting minorities towards sub-prime loans). Recently, regulatory and industry focus has concentrated on appraisers and the valuations assigned to properties as key forms of abuse.

Collusion: Requires abuse or illegal activity by two or more parties within the real estate and lending transaction. For the mortgage world, collusion often times centers around a seller who is orchestrating fictitious deals, paperwork, market manipulation, and borrower schemes in a “for profit” effort. Historically, large fraud committed against lenders has involved extensive collaboration among several criminal teams / players both within and outside the organization.

Theft: While theft was concentrated for many years against borrowers, an increase in theft directly against lenders has been experienced. Perpetrated by a “middle man” or industry knowledgeable con artists, unsuspecting buyers and lenders are duped into false transactions, “forced” to relinquish land titles, or suffer theft of financial or identity information. The criminals use this information not only to financially gain from the immediate transaction, but often times use the privileged data to forge illicit deals unassociated with the original illegal event.

Schemes: Very visible in legislative actions across the country, these illicit “playbooks” involve property “flipping,” property or value inflation in an effort to get borrowers into larger loans, predatory lending, mortgage “rescues,” nominee loans, equity skimming, silent seconds, “air loans,” backward applications, and overstating of collateral just to name a few³. These schemes share a common thread -- seek the weakest links within the organizational “hand-offs” where exploitation of a customarily legal practice or transaction can occur (analogous to an organizational process improvement initiative identifying inefficiencies). The more complex efforts require co-conspirators or collaboration that include criminal roles of “straw-buyers,” a buyer “coach,” and criminal SME’s (i.e., subject matter experts - lawyers, loan officers, appraisers).

It is unfortunate that the American dream of homeownership which stands at its highest level in history at over 70% is transformed into a lasting nightmarish situation that preys on the elderly, the struggling middle class, and our growing immigrant population. Since the M-FACTS are

³ “Operation Quick Flip,” Federal Bureau of Investigation, December 14, 2005, Page 2.

committed against those groups that lack a collective voice to fight back or band together, we can now understand why the estimates of \$1+ billion dollars of losses maybe grossly underestimated.

The FBI notes that for the periods of 2003 and 2004, the states with the largest incidents of fraud per capita consistently included: California, Colorado, Florida, Georgia, Illinois, Missouri, Nevada, and Utah. Jeffery Taylor adds, "Risk mitigation requires the customization of predictive controls rather than the historical adherence to inflexible and static point-based solutions. The failure to incorporate varied digital informational sources, results in workflow inefficiencies and an allocation of scarce resources to transactions that should be viewed immediately as suspect and probably rejected for further organizational actions." Simply put, Jeff says "There is too much garbage in the pipeline which with proper data and industry integration would greatly reduce the amount of fraud while increasing the profitability of corporate deals."

C. Richard Triola, President & CEO of Settleware Secure Services, Inc. concludes, "With the coming of the rules/permission-related electronic workflow, many of the issues of abuse and collusion can be deterred if not, prevented all together. With the Secretary of State's oversight of our eNotarization process of sensitive, high value documents, questionable notary activities by suspended/suspecting notaries can be shut down in an instance before any damage can be done. The eventual digital tie-in to the databases such as the FBI will also serve as a deterrent to the unscrupulous parties." Indeed, as this touches a subject of interest for our next article on M-FACTS.

In this first of a two part article series, we've worked to establish a baseline for mitigation recommendations at the same time as properly framing the market situation and concerns. The second article in the series will concentrate on promoting sustainable solutions using processes and technology in an attempt to improve organizational profits and superior credit quality. Additionally, we will discuss that technology solutions without proper workflow and process changes, will lead to sub-optimal and expensive organizational follies.

As we review our organizational challenges in dealing with industry's criminal elements, we must address the root causes of the M-FACTS with iterative and adaptable solution sets - without adaptability we are destined to repeat the mistakes that fundamentally created the current situation. Taking a line from the once popular TV and movie character Joe Friday from the show Dragnet, "please, give me just the M-FACTS ma'am."