

# Mortgage Fraud:

*What is it?*

*How much is it costing you?*


*How can costs be minimized?*

May 2, 2005

MBA National Secondary Conference Fraud Panel

*Strategic Decision Support*

*Providing risk assessment  
consulting to the financial  
services industry.*

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**Introduction:**

My goal this afternoon is to provide some basic information on what fraud is, what it is costing securitizers, and what can be done about it. Information presented in this presentation is from publicly available sources, several mortgage lenders, and The Prieston Group's ("TPG") internal fraud database. The TPG database includes information on roughly 400 thousand loans with 592 claims.

**What is mortgage fraud?**

For purposes of this analysis we have defined fraud to be any "**material inaccuracy** in the financial information disclosed by or on behalf of the borrower during the origination of the loan." It can be broken into 2 sub-classifications:

- Fraud for Housing (Borrower Fraud)
- Fraud for Profit/Commission (Industry Insider Fraud)<sup>1</sup>

While all fraud is an issue, fraud for profit which represents 80% of all reported mortgage fraud is the critical component.<sup>2</sup>

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<sup>1</sup> Including Commission Fraud which is broken out by MARI.

<sup>2</sup> Statement of Chris Swecker, Assistant Director, Criminal Investigation Division, FBI before the House Financial Services Subcommittee on Housing and Community Opportunity. October 7, 2004

### Who does mortgage fraud hurt?

- Borrower caught in “Fraud for Profit” scheme who overpays for their home
- Potential homeowners who are impacted by over inflated pricing
- Originators / securitizers who are subject to fraud clauses in repurchase agreements
- **Securitizers who suffer from higher credit support levels due to expected fraud losses – resulting in poorer execution throughout the mortgage chain**
- Servicers and Master Servicers whose work load increases significantly as fraud levels rise.
- Investors, especially lower tier, who absorb losses
- Rating agencies, if fraud levels do not correlate to their expectations

### How big is the problem?

According to Chris Swecker, Assistant Director, Criminal Investigation Division, FBI,

“A significant portion of the mortgage industry is void [*sic*] of mandatory fraud reporting. In addition, mortgage fraud in the secondary market is often under reported. Therefore, the true level of mortgage fraud is largely unknown. Based on various industry reports and FBI analysis, **mortgage fraud is pervasive and growing.**”<sup>3</sup>

### Is the problem growing?

- From January 1, 2001 though September 30, 2003, Suspicious Activity Report (SAR) filings for home equity loans and secured loans (excluding automobile loans) increased 56% and 41% respectively.<sup>4</sup>
- From 2001 through 2003, Loan Performance has seen significant increases in Early Payment Defaults (EPD)<sup>5</sup> and MARI has had more incidents reported to their Mortgage Industry Data Exchange database.<sup>6</sup>

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<sup>3</sup> Statement of Chris Swecker, Assistant Director, Criminal Investigation Division, FBI before the House Financial Services Subcommittee on Housing and Community Opportunity. October 7, 2004. Emphasis added.

<sup>4</sup> The SAR Activity Review Trends, Tips & Issues, Issue 7, August 2004. SARS reporting only covers activities at federally insured institutions.

<sup>5</sup> Early Payment Defaults are defined as loans 90 or more days delinquent in the first year. While these loans do not necessarily involve fraud many include some form of misrepresentation.

<sup>6</sup> MARI’s Sixth Annual Case Report to MBA, June 2004.

### What does mortgage fraud cost securitizers?

Every issuer is faced with providing credit support to cover fraud losses. Since there is no industry wide fraud analytic database, the rating agencies are limited in their ability to estimate losses from fraud with precision. However, it is obvious that **if** the fraud carve-out could be decreased, pricing would be improved on securities. Following are some simplified pricing differentials between the subordinated tranches and non-subordinated tranches.

<b>Grade</b>	<b>AAA Price</b>	<b>Subordinated Price</b>	<b>Cost of Fraud Carve Out</b>
Prime	100%	89%	<b>11%</b>
Alt A	100%	85%	<b>15%</b>
Sub Prime	100%	83%	<b>17%</b>

Issuers are also sometimes subject to repurchase agreements which obligate them to repurchase loans identified as fraudulent. However, we currently have no ability to quantify this cost.

Without better analysis of causes of defaults and industry wide tracking, there is no really good way of estimating the overall cost of fraud in the industry.

**Lack of standardized industry wide data:**

Since there is no good industry wide database, and many companies do not adequately analyze the cause for defaults, many companies – even for internal analysis - use early payment defaults (EPDs) as a proxy for the fraud incidents.

Even here the data is not consistent. Some companies use default in first 3 months. Others use 90 days delinquent in 12 months. Per QC-MAC, HUD considers a default within 24 months to be an EPD.

What is clear from information gleaned from conversations and reviews of internal company reports, is that **the shorter the time period from origination to default, the more likely it was caused by fraud.**

In this presentation, SDS has included information from companies using EPD as a proxy for fraud as well as information from TPG's claims database. Information on the following pages focuses on the variability of fraud levels based on pre-funding controls from non-TPG clients as well as information from the TPG database. We hope you will find it both interesting and useful.

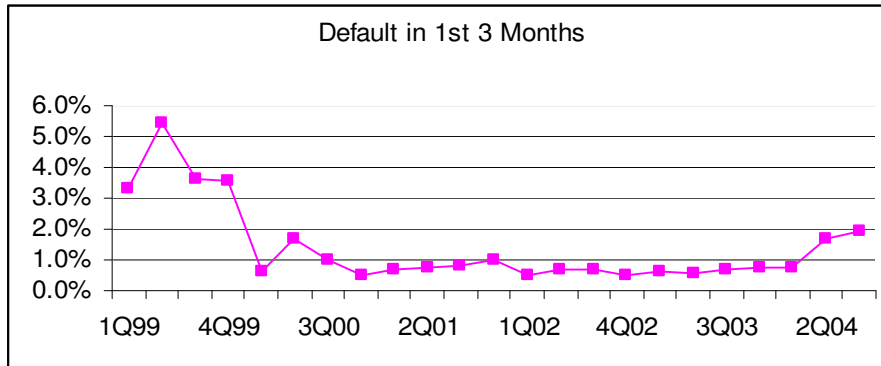
### How much difference do pre-funding controls make?

The table below shows the impact of one subprime lender's<sup>7</sup> ongoing efforts to improve controls.

Year	EPD in 1 <sup>st</sup> 3 Months as proxy for Fraud Incidence Rate	Severity ( approximate)	Fraud Losses as % of Original Balances
1999	4.0%	30%	1.2%
2003	.7%	30%	0.2%
<b>Improvement</b>	<b>3.3%</b>	<b>No Change</b>	<b>1.0%</b>

If industry wide data was available supporting differences in performance by originator and consistency of performance, rating agencies could make finer distinctions in their underwriting requirements. However, even if we had good data at a point in time, consistency is harder to maintain and prove.

### Here is what happened over time for the lender in the prior example



- 1999 – They learned a lot the hard way
- 2000 – They tightened controls and standards
- 2004 – They got hungry for volume

<sup>7</sup> Not a TPG client.

In another case, a major mortgage originator<sup>8</sup> was able to reduce the level of repurchases from 12.7% in 1995 to 1.3% in 1997 after implementing controls.

TPG, in recognition of the importance of training and controls, certifies clients after they have fully implemented TPG's proscribed anti-fraud controls. There is strong evidence, at the aggregate level that this training significantly reduces fraud incidents.

**Fraud controls must be implemented and enforced continuously!**

**Make sure your strengthened controls protect against changes in:**

- ★ Volume – Extreme volume may disrupt controls, significant declines in volume may cause some companies to accept risk in order to maintain volume
- ★ Housing price appreciation – The disappearance of rapidly rising prices will increase losses related to fraud that were covered before.
- ★ Economy – Losses in “Fraud for Housing” are likely to increase if overleveraged borrowers experience job losses.

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<sup>8</sup> Not a TPG Client.

**So what did we learn from the TPG Insurance Claims Database?** Here is some summary information from our analysis<sup>9</sup>:

1. Over 95% of claims were made in the first 24 months
2. While claims incident rates varied significantly by client, there was a clear reduction over time which we attributed to the implementation of TPG proscribed pre-funding controls.
3. Incident rates for grades A, B, and C were not statistically different.
4. Most claims had more than one material misrepresentation. The table below shows the distribution of misrepresentations by type for the 592 claims examined.

Occupancy	162
Appraisal	38
Straw	35
Employment	30
Funds	16
Flip	15
VOR	14
Broker	12
Identity	12
All Other <sup>10</sup>	20

5. Loans that defaulted in the first twelve months had a 10% probability of including one or more material misrepresentations.<sup>11</sup>

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<sup>9</sup> Details of database analysis are included in appendix.

<sup>10</sup> Credit, Investment, Self-Employment, SSN

<sup>11</sup> Per internal TPG report. Other firms, using more stringent early payment default definitions (Default in first 60 days); have proven that over 40% of EPDs include material misrepresentations. EPD is not a claim requirement for TPG.

6. Collateral and Borrower Characteristics on Claims<sup>12</sup>
- ★ LTV 81%
  - ★ Refi 12% / Purchase 88%
  - ★ Individual Borrower 91% / Joint Borrowers 9% -
  - ★ Full Doc 80%
  - ★ Stated Income 16%
  - ★ FICO 646 mean
  - ★ Age 38

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<sup>12</sup> TPG 2/14/2005 Teleconference PowerPoint Presentation.

**Ancillary benefits of TPG Fraud Assurance Solution:**

SDS will be working with TPG clients to gather pre-certification performance on client loans in order to analytically value the other key components of the TPG Fraud Assurance Solution. These components are:

1. Standardized pre-funding loan review procedures to detect and prevent fraud.
2. “Fraudster” list of industry professionals.
  - ★ Ineligibility List of individuals/companies associated with fraud drawn from TPG experience
  - ★ Advisory List of individuals/companies associated with fraud per companies outside TPG.

We already know from our review of non-TPG clients and aggregate TPG client incident rates over time that implementing specific fraud targeted controls makes a significant difference in the level of fraud incidents.

### **How can you reduce your losses from fraud? Get practical guidance at:**

#### MBA Online Anti-Fraud Center

The resource center will include such information as fraud-alert updates on emerging fraud schemes, a Lender Tool Box to help lenders protect themselves against fraud, and a resource library of reports and Web links. <http://mbafightsfraud.mortgagebankers.org>.

#### Quality Loan Review

“Quality Loan Review” is dedicated to providing brief overviews of current fraudulent activities that pose serious legal and business concerns for the mortgage banking industry. To subscribe contact [Subscription@QualityLendingReview.com](mailto:Subscription@QualityLendingReview.com)

#### Mortgage Fraud BLOG

The information on this blog is from various public sources and is compiled as a service to those interested in mortgage fraud by The Prieston Group. <http://www.mortgagefraud.org>

#### **Recommendations:**

- 1. Reduce the incidence of fraud, use the expert resources listed above.**
- 2. Participate in industry efforts to establish a fraud data base. Start tracking information NOW!**
- 3. Support reduced subordination levels, through consistently superior performance by documenting low levels of**
  - ★ early payment defaults and proven frauds
  - ★ realized losses, after aggressive loss mitigation work
- 4. Evaluate use of insurance to protect against uncertainty of fraud losses.<sup>13</sup>**

**Questions?** E-Mail [Pat.Schwinn@SDSupport.com](mailto:Pat.Schwinn@SDSupport.com) or Call 510-339-2669.

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<sup>13</sup> TPG is in dialogue with S&P on the use of insurance as a form of credit enhancement.

**Appendix:** SDS was asked to provide an independent assessment of the value of insuring against fraud as a potential substitute for subordination. At the time of the analysis, the database included information on 392 thousand loans approved for insurance and all related claims from inception through 12/9/2004. Following is a quick recap of our methodology.

2. Examined claims distribution over the 36 month insurance window.
3. Examined statistical differences in claims by grade and client (originator/issuer)
4. Calculated Benefits by credit grade and vintage as follows.
  1. Loss Mitigation Expenses were based on actual for all years.
  2. Loss Avoidance from Loss Mitigation was calculated using the estimated loss (TPG formula) for all loans whose status/status reason was “Closed without Pay: Loan Sold, Loan Refinanced, or Loan Paid Off.”
  3. Insurance payments for closed claims were based on actual using actual policy limits.
  4. Benefits for claims “Awaiting Payment” and “Pending” were calculated using TPG formula which is based on outstanding loan balance less estimated property valuation. Property valuations were based on most recent appraisal less reduction for historic relationship between REO sales price and updated appraisals.
  5. No estimation of fraud avoidance was made.

The analysis also utilized internal TPG reporting and analysis.