

Ways to Combat Costly Collateral Fraud

Software can help lenders lessen the risk of some of the most-damaging types of fraud

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FRAUD IS A GROWING PROBLEM and has become a serious issue throughout the mortgage industry. As such, mortgage brokers can expect their wholesale lenders to be concerned with fraud-risk-mitigation in the months ahead. Knowing the most-common types of fraud and what lenders are doing to mitigate fraud will help make brokers better partners in the lending process.

There are three primary types of fraud that residential mortgage lenders encounter: credit-enhancement fraud, equity fraud and collateral fraud. Of these, collateral fraud, which deals with the integrity of the collateral itself, is the most dangerous and costly.

Types of fraud

Credit-enhancement fraud involves schemes designed to get borrowers into homes for which they do not qualify. They are also designed to increase loan officers' commissions.

These crimes generally involve misrepresenting information relating to the borrower's credit, employment or income. If the home is a primary residence and if the loan-to-value ratio (LTV) is low enough, lenders face limited risk when they approve these deals. Although it is certainly important to limit this type of fraudulent activity, lenders can cost-effectively manage the ultimate cost.



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Equity-fraud schemes involve falsifying information to remove equity from the value of a real estate asset. This type of fraud often includes identity theft or investor schemes. In combination with national fraud databases, some tools have helped mitigate much of this activity.

Collateral fraud involves misrepresenting information to inflate the real estate asset's perceived value with the intention of profiting from the deception. Types of collateral fraud include appraisal fraud, land flips and builder bailouts. The risks associated with this and other types of mortgage fraud are compounded when the fraud on the file consists of multiple and overlapping fraud categories.

Because the collateral that underwrites the loan is the insurance policy that protects lenders from bad loans, collateral fraud is the most costly to lenders and until recently, the most difficult to detect.

The advent of AVMs

Historically, collateral fraud has been managed manually through appraisers, brokers, underwriters and other market participants in a more regional lending environment. Although this process worked adequately in typical market conditions, it strained and often broke during certain high-volume, volatile market conditions and during market consolidation.

As mortgage volumes skyrocketed at the end of the 1990s, lenders became less capable of reviewing appraisals for each deal. Quality control focused on a small subset of total loans written, and there was little information to focus lenders' attention on potential trouble spots in their lending area. This problem was exacerbated for regional and national lenders that depended even more on appraisal professionals in dispersed geographical markets.

The advent of dependable automated valuation models (AVMs) was a boon to lenders. They could use these fast, computerized models to perform quality control on larger subsets of their deals to find discrepancies between the model's expected valuation and the appraiser's report.

In the recent past, automated tools have

emerged that are designed to access public records and to determine quickly whether a property's valuation differs significantly from the appraiser's evaluation.

Although these systems are evolving rapidly, they historically have fallen short for broad applications. This is because they were not designed to consider all the available information impacting the subject property, the transaction or the totality of its associated mortgage risk. In other words, AVMs were never intended to be all things to all people.

Modern software

Today, modern fraud-identification and risk-mitigation software goes beyond the AVM or the subject-property history report and accounts for more information before rendering a collateral-risk score. In fact, the best models consider thousands of data points — e.g., the subject property, comparable real estate in the area and the market environment — to predict mortgage risks accurately. This is important because looking at the subject property alone does not provide enough information to determine the presence of fraudulent activity or the overall risk involved in making the loan accurately.

Numerous tools compare a property's value with values of comparable properties in the area. But investigating the subject property and the surrounding environment must go beyond value to other data points. These include the number of foreclosures in the area, the number of recent sales, the neighborhood's population density, the land use in the vicinity, forecasting trends and market volatility.

The best models go beyond analyzing the subject property and properties that surround it. They also include information about the market and the economy in general. They account for market volatility and general economic indicators, too.

Today's real estate databases are brimming with property-related information that can be tapped and evaluated by high-speed computer models. The availability and access to this data is

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paramount for the accurate and efficient identification of fraud and risk, which ultimately benefits consumers in lower costs and a more efficient mortgage market. It is possible to compare every aspect of the subject property to every aspect of all properties in the neighborhood. It's also possible to get a risk score that tells the lender the likelihood of misrepresented information or the degree to which risk is inherent.

Increasingly, lenders are using sophisticated forecasting tools to evaluate a deal's overall risk. Some of these models can give lenders an accurate idea of what the subject property will be worth in the years ahead. Having this forward-looking element, in addition to the historical analysis, can lead to more-accurate collateral-risk scores.

The mere presence of information related to a property or a deal, however, does not guarantee that a lender will be in a position to use it effectively or to reach a better decision. For most lenders, automated systems analyze the data and return recommendations, most often in the form of scores and supporting data. Lenders then can build their own business rules to act depending on the risk score returned for the collateral.

Building rules upon models that do not account for all relevant data is an invitation for increased risk and ultimately, higher incidence of fraudulent activity.

Keeping business on track

Lenders are intent on deploying tools to mitigate the risk of all types of mortgage-related fraud, but they often are slow to implement changes that will increase their ability to serve good customers in a timely fashion. Fraud-risk-mitigation tools must be fast and easy to use. They must be integrated into common lending platforms in a way that makes it easy for lenders to get the benefits of their analysis without tying up valuable resources that would otherwise be deployed in the closing and shipping of loans.

One area in which fraud tools have traditionally fallen short is in consideration of the negative — or left-side — distribution of what is considered. In any statistical analysis, results will range above and below the expected value, outcome or event analyzed. Lenders, in an effort to mitigate the risk involved in higher LTVs, traditionally have focused on the right-hand distribution — those properties that have been overvalued and represent higher-than-expected LTVs. Consequently, developers have focused on creating models that are better at being

accurate on the right-side of the distribution to avoid overvaluing properties and assuming great risk.

But deals that fall into the tail regions in left- and right-side distributions are problematic for lenders. False positives for fraud risk or overvaluation cause deals to drop out of otherwise efficient automation, forcing lenders to expend resources to verify fraud or increased risk in a deal where it does not exist. This opportunity cost is expensive and time-consuming for lenders and can damage valuable relationships.

The model must identify overvaluations that can indicate fraud and increased mortgage risk without producing a high volume of false positives that bog down the lender's system and that increase costs.

Finally, when a collateral-risk score indicates a high probability of fraud in a deal, the model must be capable of pointing the lender in the right direction to identify the type of risk present. It is not enough to know that a property does not conform to the model's predicted parameters. The lender must know why it does not conform and how to verify the deal quickly or to decline it appropriately.

An end to collateral fraud?

Misrepresentation of the value and integrity of the collateral in the mortgage-lending process will continue to be the most costly and dangerous type of fraud lenders face. To deal with this threat effectively, lenders must use all the available real estate information to determine the risk inherent in their deals quickly.

Lenders should thus choose models that take full advantage of the full spectrum of property information, historical information and accurate forecasts. The models also should focus on more than the subject property itself; they also should extend to the neighborhood and the market in general.

Lenders should work with vendors who are adept at seeking this data, at integrating the data into proven models, at producing accurate risk scores and at reporting them quickly and efficiently.

Brokers should expect lenders to be more interested in all aspects of the collateral used to underwrite mortgage deals going forward. They should also expect to see technology employed that will help lenders dig deeper into the specifics of the collateral and how it has been evaluated. Brokers that understand and facilitate lenders' need to mitigate fraud risk will be more successful in the future. 