



**First American**  
**Real Estate Solutions™**

**Project:** First American Real Estate Solutions Fraud Article

**Assignment:** Write an article showcasing Loan IQ and positioning First AMRES as a fraud expert. Article will run in National Mortgage News or similar trade publication.

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**Working Title:**

**Caveat Fraudator (Let the Fraudster Beware)**

*Mortgage Fraud Detection Tools Reach Higher Levels of Sophistication*

by Ben Graboske, VP/CTO  
First American Real Estate Solutions

*Ben Graboske is vice president/CTO for First American Real Estate Solutions, a member of The First American Corporation (NYSE: FAF) family of companies.*

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Once upon a time in a little town called Bedford Falls, the Bailey Building and Loan Company built houses and provided mortgages for the townspeople. The loan process was fairly simple: Since George Bailey knew everyone in the town personally, he could vouch for their ability — and their trustworthiness — to honor the loans.

Today's mortgage industry is vastly different from that portrayed in "It's a Wonderful Life." Rather than doing business with your fellow townsfolk at the neighborhood bank, mortgage lenders now do business with borrowers all across the country. In addition, broker and internet loan applications represent an increasing share of the marketplace. With more and more applications being processed electronically, direct, face-to-face contact between borrowers and lenders has become the exception rather than the norm.

To complicate matters further, the demand for faster closing times has increased exponentially, forcing lenders to find new ways to streamline and automate the loan approval process. For example, automated underwriting is used to offer instant decisioning regarding a loan request, though this process still requires some form of property appraisal. Drive-by appraisals, where an appraiser examines the outside of the subject property and the neighboring areas, saves time over traditional appraisals, which are often difficult to schedule and time-consuming to perform. In addition, all the top mortgage lenders have incorporated AVMs, or Automated Valuation Models, into their business systems. AVMs are computer-generated residential property appraisal reports. Created instantly, AVMs can significantly reduce the time required to obtain an estimate of value, and cost significantly less than the typical physical appraisal process.

Regardless of how the property valuation is generated — by human being, by computer or by a combination of both – fraudsters still know how to get around the system. As a result, mortgage fraud has become increasingly more prevalent and more difficult to prevent. And while the loan process has greatly benefited from technology in recent years, fraud detection tools are just beginning to realize similar gains in sophistication.

### **Types of Mortgage Fraud**

There are two main categories of mortgage fraud as identified by the FBI: *Fraud for Housing* and *Fraud for Profit*. Fraud for Housing is fairly common: Applicants boost their incomes and generally paint a rosier picture of their financial situations to qualify for loans they might not otherwise deserve. Nevertheless, these applicants are true buyers who simply want to obtain the house of their dreams, and who fully intend to make their monthly mortgage payments so as to keep that dreamy roof over their heads. Fraud for Profit applicants, on the other hand, have no intention of occupying the property in question; rather, they are trying to defraud the lender and walk away with a fistful of dollars.

Fraud for Profit can assume many different forms. *Property flipping*, for example, occurs when a home is purchased at one price and sold a short time later at a higher price. This can be costly to a lender. Not all property flipping is fraudulent, however; some buyers purchase the residence, spend time and money fixing it up, and then resell it at a higher price. On the other hand, frequent flipping of the same residence, especially by the same buyer, at increasingly higher prices is considered fraudulent.

*Collateral valuation fraud* is the most prevalent type of Fraud for Profit. It occurs when a property value is over-inflated, and can result in heavy financial loss to the lender in the event of default. Eighty percent of the time, collateral valuation fraud involves collaboration or collusion by industry insiders, such as mortgage brokers, appraisers, loan officers, lawyers and/or realtors, which makes it even more difficult to detect.

### **An Escalating Issue**

Mortgage fraud is “pervasive and growing,” according to Chris Swecker, Assistant Director of the FBI’s Criminal Investigative Division in statements made before the House Financial Services Subcommittee on Housing and Community Opportunity on October 7, 2004. In the first three quarters of 2004, the FBI had 553 pending mortgage fraud investigations, as compared to 102 investigations in all of 2001. In addition, a September 2004 press release stated that forty-seven FBI field offices in thirty-seven states were involved in 5,000 cases involving criminal groups and individuals “engaged in significant financial institution fraud.”

In the period between August 2004 and September 17, 2004 alone the FBI had 158 investigations and 144 arrests, convictions and sentences representing potential losses due to fraud against financial institutions in excess of \$3 billion. Estimates of mortgage fraud losses have been reported as high as \$60 billion per year; however, with little mandatory fraud reporting in the mortgage industry, and fraud in the secondary market often underreported, the true level of mortgage fraud is largely unknown.

### **Limiting Risk: Yesterday and Today**

To limit their risk of loss from collateral fraud, lenders must ultimately determine an accurate valuation of a property to ensure that the collateral supporting the loan is sufficient to cover the principal amount of the loan. In days past, loan originators relied on licensed appraisers, professionals who were knowledgeable in the type of real property in question and skilled in comparing such properties for a given market.

These days, many lenders go a step further by examining the history of the property or even the applicant. In regard to the property, certain patterns of frequent sales, loans or refinancings might uncover attempts to artificially raise valuations. In the case of the applicant, he or she may have been involved in a cluster of activities involving other properties in the neighborhood, which can create in the mind of an appraiser a false impression that properties in the area are appreciating rapidly. Most lenders also review applicants' credit scores as an objective measure to the loan process.

Even in the face of uncertainty, loan officers may hesitate to deny an application or to demand additional information for fear of losing a good loan. Fortunately, new fraud detection tools — based on more sophisticated technologies — are emerging to give lenders more confidence in their funding decisions. These tools fall into four main categories:

- **Collateral fraud tools** review the history of the subject property, surrounding properties, comparable properties, REO activity, flip activity and other criteria. Many of these tools alert lenders when the user-submitted value is at significant variance with AVM-based values.
- **Identity fraud tools** identify flipping activity as well as relationships between buyers and sellers.
- **Mortgage application-based fraud tools**, or 1003, validate the credibility of loan application data and property valuation, while at the same time identifying those applications that have potentially falsified information or data input errors.
- **Broker and appraiser fraud tools** provide background checks on individuals involved in property valuation.

Although these tools have enhanced lenders' ability to minimize risk, fraudsters continue to find ways around the system. At the end of the day, no single tool can protect all lenders against all fraud; rather, a combination of tools wrapped around AVMs is necessary for lenders to confidently arrive at a definitive “yes” or “no” answer to the funding question.

### **Limiting Risk: Today and Tomorrow**

First American Real Estate Solutions (RES) has developed Loan IQ, a new breed of fraud detection technology that can effectively tell lenders how to treat loan applications *before* funding. Built on a predictive modeling method known as *logistic regression analysis*, a commonly used technique for loan default modeling, Loan IQ employs a two-stage regression. Stage One is to determine an objective estimate of the property's value using RES' sophisticated

AVM technology. Stage Two analyzes fraud predictor variables, such as transfer history and seller, owner, loan and property characteristics.

Loan IQ is accessed via the Internet for ease of use, and compatible with most lenders' current loan origination systems, which minimizes the number of process changes required to accommodate the technology. To use Loan IQ, a lender simply types in the property address, the borrower and seller's names, the requested loan amount, the estimated value, sale price or appraised value, and whether or not the property is classification as new construction or previously occupied. Loan IQ responds with a value in one of three categories: "Satisfactory," "Unsatisfactory" and "Marginal."

[SHOW SAMPLE SCORING?]

The Loan IQ scoring model enables lenders to speed up the approval process for good loans and to refuse to fund unsatisfactory loans, both with a high degree of confidence. It also tells lenders where to apply additional due diligence, saving time and lowering overall per loan costs. While the mortgage industry may never again be as simple as it was in George Bailey's universe, with Loan IQ, it can be almost as risk-free.

*For more information on First American Real Estate Solutions and Loan IQ, contact Ben Graboske at (714) 701-3735.*