Scrubbing Loans *for* Extra Credit

— by GREG HOLMES —

Lenders are taking advantage of new technology to reduce mortgage fraud, provide better service to customers and maintain investor compliance.

You would never expect a doctor to head into the operating room without surgical equipment and a well-scrubbed support team. Likewise, most chefs depend on top-notch kitchen tools and appliances to create and prepare flawless dishes for their restaurant patrons. ¶ These professionals know the importance of having the right tools to get the job done efficiently and effectively. Why should it be any different in the mortgage lending profession? ¶ A key aspect of a mortgage lender's job is to verify an applicant's employment status, salary, credit history and other financial information to determine the applicant's creditworthiness and ability to repay a mortgage loan. ¶ When an applicant is approved, the lender must make sure the borrower is still qualified for the loan at closing. This shouldn't be difficult, but sometimes mortgage fraud can make it a challenge to get the job done on time and without risk. ¶ Although there has been closer scrutiny of late by regulators and new guidelines put into effect by lending agencies and regulators, mortgage loan fraud continues to be an issue. Various industry fraud statistics clearly document the scope of the problem. ¶ For example, Fannie

Mae reported in its December 2012 Mortgage Fraud Findings Statistics Update (https://www.fanniemae.com/content/fact_sheet/mortgage-fraud-statistics-1212.pdf;jsessionid=55bef229c28b58ac59b8ba6c9d101930.cportal-cl02) that in cases of misrepresentations related to loan originations of loans delivered to Fannie Mae in 2011 and 2012:

- 40 percent included misrepresented borrower liabilities;
- 14 percent found that the borrower's intent to occupy the subject property was materially misrepresented;
- 18 percent included inflated or fabricated borrower income/employment information;
- 15 percent contained a material fact about the property and/or the comparable sales that was misrepresented;
- 7 percent included a discrepancy in the Social Security number(s) used to qualify the borrower(s);
- 3 percent contained inflated property values and non-property-related misrepresentation in the loan transaction;
- 2 percent contained inflated or fabricated borrower asset information; and
- 1 percent included misrepresented borrower credit history.

Significantly, 40 percent of all misrepresented mortgage originations in 2011 and 2012 are a result of new undisclosed liabilities—up from 27 percent in 2010.

New liabilities, such as a new credit account or an additional loan application, constitute the majority of mortgage loan fraud. The ability for mortgage lenders to uncover undisclosed debt has always been critical to control exposure to defaults and loan repurchases.

The agency and investor guidelines do not consider new debts.

Regulations put burden on lenders

The issue of borrower misrepresentation gained even more significance when Fannie Mae announced its Loan Quality Initiative (LQI) in June 2010. The LQI is broad in scope and creates extra steps for mortgage underwriting. It recommends validation of items such as borrower occupancy and Social Security numbers.

LQI also recommends that lenders establish processes to identify all of an applicant's liabilities, including those that occurred during the "quiet period"—the time between application and the closing of the loan.

LQI recommendations for identifying borrower liabilities call for lenders to:

- verify that borrowers have not incurred new debts and liabilities;
- review the debt-to-payment ratio; and
- requalify borrowers who obtained additional credit prior to closing.

The agencies continue to update their guidelines and have announced a new quality-control model that shifts the focus of Fannie Mae and Freddie Mac's loan-quality reviews closer to when the loan is delivered versus when a loan goes into default.

In its January 2013 report, *Zooming in on Undisclosed Debt: The Risk and Implications of Undisclosed Borrower Debt in Mortgage Lending,* Atlanta-based Equifax Inc. estimates that up to 100 percent of the loans delivered to Fannie Mae after Jan. 1 of this year will go through the new quality-control review process.

Another recent set of rules to address mortgage lending practices was issued in January of this year and is scheduled to take effect in 2014. The Consumer Financial Protection Bureau (CFPB) released its Qualified Mortgage (QM) rulemaking, which includes lending standards that will protect lenders from certain legal liabilities if they adhere to guidelines in the rule designed to ensure borrowers have the ability to repay their loans.

The QM definition outlined in the rule also requires lenders to keep debt-to-income (DTI) ratios below 43 percent. Unfortunately, compliance with the rule most likely will add to the overall compliance burden for lenders.

Managing DTI is critical for lenders

Equifax's *Zooming in on Undisclosed Debt* paper shows that additional trade lines are more likely to increase DTI by 3 percent or more. The report also found that additional trade lines are likely to result in expensive loan repurchase demands by the secondary market or penalties by regulators, including Fannie Mae, Freddie Mac, investors in private-label, residential mortgage-backed securities (RMBS) and the Federal Housing Finance Agency (FHFA).

Data from the Equifax report shows that 36 percent of borrowers who assumed one new trade line of undisclosed debt during the quiet period had a DTI increase of 3 percent or more. And, not surprisingly, that figure jumps to 79 percent for those borrowers who opened three or more trade lines.

New undisclosed debt puts borrowers at risk for closing

Most borrowers are willing to disclose their debts when they initially complete a mortgage application. However, they may not always provide all the information that the lender requires for the loan origination.

"The customer typically is not intending to defraud us when they complete the initial loan application. They may forget to add a payment that is auto-deducted from their checking account or may not read the application closely and don't realize they are required to disclose child support, for instance. If the information is not on the credit report and the loan officer does not ask probing questions, they just don't think about the impact. We see that far more than any kind of intended fraud, but the results are the same," says Christine Rhea, president of Knoxville, Tennessee–based Mortgage Investors Group.

Traditional underwriting ratios and guidelines take continued purchasing on existing credit lines into account. However, the agency and investor guidelines do not consider new debts. Borrowers continue to go on with their lives during the quiet period; they buy gas for their cars, eat out and shop for new clothes using credit cards.

"The types of undisclosed borrower debt we see most often are purchases of items such as cars and appliances, followed by credit-card debt and cash advances," says Mark Sheridan, vice president of AMX for the Wholesale Lending Division of Land Home Financial, Concord, California, a wholesale lender licensed in 42 states.

Buying a new home can trigger purchases of new furnishings and household appliances for many borrowers.

According to Equifax, 14 percent of mortgage applicants obtained new debt during the quiet period. This figure was as high as 40 percent for some lenders. Equifax also found that the average monthly payment of this new undisclosed debt was $251.

"Many borrowers don't realize how new debt can affect their ability to qualify for a mortgage," explains Rhea.

"The cases where we may have to stop the closing to make sure we captured additional debt and determined whether the borrowers still qualified for the loan are usually the couple buying the new appliances who didn't take us seriously when we said they should not increase their indebtedness until after they close and have adjusted to the new house payment," Rhea adds.

Credit reports are useful, but don't provide a complete picture

Today, the tool many lenders use to comply with Fannie Mae's loan-quality guidelines is a credit report pulled immediately prior to a loan closing to help confirm that no new debt has been taken on by the borrower.

One of the challenges with this option is that both the lender and the borrower are unaware there is a problem until a few days or hours before the scheduled closing.

"It certainly helps to know more than 48 hours before closing whether the borrowers still qualify for their loan. Even though the borrower opened up a new trade line during the quiet period and the issue was not caused by our company, anytime a loan doesn't close on time there are unhappy buyers, sellers and Realtors®," says Rhea.

"Our reputation is on the line when a loan doesn't close, since borrowers don't always explain to their best friends or their next-door neighbors that it wasn't the lender's fault that they did not close on time," she adds.

Monitoring technology can help minimize risk

Rather than relying on a snapshot of borrower credit behavior at application and again at closing, lenders can now improve the process with a quality-control technology tool. This tool continuously monitors credit inquiries, new trade line placements and new monthly payments as they occur during the underwriting process.

Quality control programs such as Credit Plus' Undisclosed Debt Monitoring™ (UDM), powered by Equifax, are designed to help lenders meet Fannie Mae's LQI recommendations and check borrower credit activity during the processing of a mortgage. The tool offers users continuous monitoring and daily proactive alerts on potential risks on a borrower.

Quality-control technology enables lenders to identify risk earlier in the underwriting process. This allows them to meet with the borrower and take the necessary steps to change the loan terms, gather additional documentation needed for investors or determine another resolution prior to closing.

Only those loans that have been pre-approved or those that are likely to close are monitored, which significantly reduces processing time, costs, delays and loan fallouts.

"Before we had debt monitoring, we used a process of credit compare—which meant that 24 hours before closing, we were comparing that day's credit to the day we ran the original credit report," explains Rhea.

"If we discovered a new debt the day before closing, it could mean a delay in closing. With Undisclosed Debt Monitoring, we are notified on a daily basis—usually early in the process—if there has been activity on a borrower's credit profile, such as an inquiry or a new trade line. It's an effective way of catching things at the early stages of the loan rather than the day before closing, which has been a tremendous help to us," Rhea says.

She adds, "Another valuable benefit of debt monitoring has been the assurance of risk prevention for our company. We feel confident that we are discovering and managing the impact of any undisclosed borrower debt before closing. It really does eliminate our risk of potential loan repurchase from a borrower default or when a loan is pulled for a quality-control audit."

Sheridan agrees. "With the implementation of Undisclosed Debt Monitoring, one major fraud-detection activity has been automated for us and we have peace of mind in that it is being done correctly. Every loan is now monitored for agency compliance. UDM also has been valuable in assisting us with reducing cost by an estimated 3 percent."

Other fraud-prevention tools for lenders

Quality-control technology is only one of the ways lenders have found to combat mortgage fraud. There are other mortgage fraud-prevention technologies that lenders have added to their toolboxes to streamline lending processes.

Lenders have found tax-return verifications effective in validating a borrower's income. For example, tax-return transcripts requested from Credit Plus more than tripled from Jan. 1, 2010, to Dec. 31, 2012. The increase in tax-return transcript requests received from 2011 to 2012 was 54 percent. This technology compares income-related lines of the borrower's tax return with actual data on file with the Internal Revenue Service (IRS).

Based on Fannie Mae's fraud findings for 2011 and 2012 originations, in 18 percent of misrepresentations, the borrower's income or employment information was inflated or fabricated.

Identity validation is another useful tool that uncovers identification discrepancies by using validation scores, warning messages, income estimates and watch-list checks.

Fannie Mae's *Mortgage Fraud Findings Statistics Update* also showed that 7 percent of misrepresentations were because of a discrepancy in the Social Security number used to qualify the borrower. A tool to help prevent these types of misrepresentations is Social Security verification, which is used by lenders to ensure the borrower is using a legitimate Social Security number.

Although borrower misrepresentation continues to be a challenge for the mortgage lending industry, lenders now have a variety of tools available to enable them to quickly and efficiently combat mortgage fraud and minimize risk. **MB**

Greg Holmes is national director of sales and marketing for Credit Plus Inc., Salisbury, Maryland, a provider of credit and mortgage information services since 1928. He can be reached at beyondbundled@creditplus.com.