

SERVICING MANAGEMENT®

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Enhance Your Ability To Quickly Identify Likely Fraudulent Loans

Identifying and monitoring high-risk loans through collateral-risk assumptions can enable servicers to uncover fraud.

Fraud presents one of the most costly risks associated with mortgage contracts because it commonly results in large losses and usually occurs early in the mortgage contract lifecycle.

The latest statistics from the Federal Bureau of Investigation (FBI) indicate that fraud is steadily rising, and home buyers, home sellers, lenders and servicers are all at risk of losing substantial amounts of money. FBI suspicious activity reports have tripled to 21,994 in the last two years, and the dollar value of these alleged crimes has quadrupled to \$1.01 billion. This is likely to be a conservative estimate of the cost of fraud in the mortgage industry, because not all fraud is reported to the FBI.

There are two general types of fraud: fraud for housing and fraud for profit. Fraud for housing usually involves borrower misrepresentation of such things as income, assets or debt, occupancy intent, or employment on the loan application. The intent is to close the loan to acquire the property and repay the loan. FBI statistics indicate that 20% of all fraud is fraud for housing.

In contrast, the remaining 80% of fraud is fraud for profit. This type of fraud usually includes industry professionals who grossly misrepresent

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such items as income, assets or employment. There is also usually a component of property overvaluation, as this is the vehicle for extraction of fraudulent dollars. The perpetrators either have no intent of making loan payments, or will do so for a short period of time while they close additional fraudulent loans.

Ultimately, when all the loans become delinquent, they have higher levels of loss severity than typical loans with similar credit characteristics. Fraud for profit is significantly more costly to the mortgage investing community than fraud for housing.

In servicing portfolios

While it is appropriate to attempt identification of fraudulent loans prior to closing, fraudulent loans will inevitably make their way into servicing portfolios. Therefore, servicers are the best defense for identifying fraudulent loans that have avoided detection by the lender. With fraud on the rise, investors depend on servicers to manage losses due to fraud.

From the servicer's perspective, management of loans through the various states of delinquency - and the ability to predict the likely transitions through these different states of delinquency - enhances the ability to identify likely fraudulent loans early on and adjust servicing procedures for these loans. This article describes techniques that can be used to further predict delinquency transitions,

identify potentially fraudulent loans and create more efficient loss mitigation strategies for these loans.

The methods for perpetuating fraud and avoiding detection have changed, but elevated collateral risk remains a constant indicator of fraud for profit. Therefore, obtaining a complete view of fraud requires flexing new and innovative collateral-centric approaches with what is already known about credit risk. The use of collateral risk tools shows great promise in further exposing underlying fraud risk and delinquency transition likelihood in a mortgage transaction.

Specifically, tools that evaluate and summarize collateral risk can be used to effectively identify and stratify the likelihood of fraud and delinquency transition. Collateral risk is measured as a function of measurement error in the loan-to-value (LTV) (the expected accuracy of the valuation used to determine the denominator of LTV) and sustainability (the likely future price appreciation/depreciation relative to local market trends and the proposed value over the life of the loan).

All valuation methods have embedded error expectations and inherent biases. For example, it can be shown that appraisals are upwardly biased when associated with certain types of refinance mortgage transactions. Additionally, an estimation is exactly that: a best estimate based on the available information at the time of the transaction.

Some methods of valuation, such

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as appraisals, have very little empirical information on technique accuracy. But others, such as automated valuation models (AVMs), have very well-known and understood accuracy measures. The types of factors that influence the measurement error of an LTV are the proximity to externalities, such as parks, waterfronts, railroads and golf courses; the availability of recent nearby sales transactions; and a lack of housing homogeneity.

Delinquency transition

The ability of servicers to identify loans with increasing measurement error in the LTV allows them to identify those loans that are more likely to transition from early levels of delinquency, such as 30 or 60 days delinquent, to higher levels of delinquency. Furthermore, it is easier to hide overvaluation and perpetrate fraud in areas where the measurement error of value is higher.

Sustainability, which is the ability of a property to maintain or increase its value into the future, is measured with factors such as the relative relationship of the subject value to nearby peers and the proportion of recent trustee sale activity in the neighborhood. When these conditions are elevated, they can indicate price depreciation pressure in the local market.

Identification of these local market conditions also helps pinpoint markets where the opportunity to perpetrate fraud exists. Trustee sales offer fraud perpetrators the opportunity to buy properties at below-market values and then sell those properties at unsubstantiated higher values. These conditions identify the possibility for increased loan losses when overvalued properties become delinquent.

Also, the ability of a homeowner to sell the property at or above the outstanding loan balance when he encounters financial difficulties and cannot make the loan payments is decreased. This is because a lack of sustainability indicates declining local price trends and increased foreclosure activity that "blight" the neighborhood and make it more difficult to

sell one's home. These loans are more likely to transition to higher states of delinquency and foreclosure than loans in low-foreclosure, sustainable neighborhoods.

Third-party collateral risk is measured by summary statistics of the transaction-level collateral risk information across all the transactions observed for a particular third party, such as a mortgage broker. For example, if a broker has been involved in the origination of 100 loans in the last year - each of which has been assigned a collateral risk score - a mean summary of the collateral risk scores for all 100 loan transactions would indicate the average collateral risk for that broker.

Borrower collateral histories are treated similarly to the third-party measures. Given that a history of ownership can be identified for the borrower, summary statistics of the transaction-level collateral risk information on all the properties associated with that borrower are created from the underlying risk factors. The combination of these risk dimensions creates a more accurate model than if only one dimension was analyzed.

The numbers

A servicer can utilize the predictive nature of these multidimensional collateral risk scores to develop efficient loss mitigation and fraud identification strategies, while remaining cognizant of the costs associated with loss mitigation.

For example, consider two loans with similar credit risk characteristics that are 60 days delinquent. If one loan has a low collateral risk score and the other has a high collateral risk score, based on empirical research, the servicer would be wise to design separate courses of servicing action. The high-risk scored loan is less likely to be curable because the score indicates poor sustainability

conditions, higher likelihood of measurement error and higher likelihood of fraud.

In a portfolio of prime loans originated last year, 48% of all loans 60 days delinquent were observed to transition into a 90-day delinquency state within the first year. Although the vast majority of these mortgages were low-risk loans, the high-risk scored loans were far more likely to become seriously delinquent.

In the same example, the transition rate from 60 to 90 days delinquent was almost 20% higher for the high-risk scored loans. This high-risk group was a very small proportion of the total sample - 4%. In addition, the small high-risk sample identified by the collateral risk scores included a disproportionate number of all types of delinquencies. The efficiency of these scores increases with more severe delinquency states.

Therefore, using collateral risk scoring to identify high-risk and potentially fraudulent loans allows one to identify a small sub-sample of loans for increased loss mitigation efforts, while streamlining the loss mitigation efforts on the sample that is more likely to cure and create cost-per-loan efficiencies.

With fraud on the rise, efficient detection and loss mitigation strategies can be achieved with the use of collateral risk tools. Identifying high-risk loans allows servicers to differentiate between a loan where the borrower has lost his job and is unable to make monthly payments from a loan that is fraudulent.

The former is a far more likely explanation for the majority of loans that have gone delinquent. But while the latter is less likely, it is more damaging to the investor and servicer. A stratification of collateral risk allows servicers to quickly and efficiently designate its resources in the recovery efforts. **SM**

