

White Paper

Mortgage Asset Research Institute

First Semi-Annual Case Report to Mortgage Bankers Association

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FIRST SEMI-ANNUAL CASE REPORT TO MORTGAGE BANKERS ASSOCIATION OF AMERICA

Introduction

The Mortgage Bankers Association of America (MBA) and the Mortgage Asset Research Institute, Inc. (MARI) have an endorsement agreement, dated April 1, 1998. A provision of this agreement calls for MBA to encourage its members to participate in MARI's cooperative database services:

- Mortgage Industry Data Exchange (MIDEX)
- LoanWatch

In return for this endorsement, MARI has agreed, in part, to provide semi-annual reports to MBA showing the results of information collected in its databases. This document is the first such report and presents the information from MARI's MIDEX and LoanWatch databases as of 12/31/98.

Purpose of the Databases

The MIDEX database contains information about incidents of irregular or misrepresented information MIDEX subscribers find in loans they originate, purchase, service, or insure.¹ MIDEX also includes public sanctions and disciplinary actions taken by regulators in the mortgage and financial services industries. Contributing subscribers then search the MIDEX database as part of their TPO or appraiser approval process.

The LoanWatch system contains information about multiple loan applications submitted by the same borrower. These applications often involve multiple, money-wasting rate locks. In addition, the multiple applications may contain information that is inconsistent. LoanWatch subscribers periodically send Form 1003 information from their application pipelines. The LoanWatch system compares selected pipeline information among competing lenders to determine where multiple applications, rate locks, and inconsistencies are occurring.

¹ See Appendix A for the descriptions of both the MIDEX and LoanWatch databases mailed to MBA members as part of the April 1998 endorsement announcement.

MIDEX Results

Hot Spots of Misrepresentation

Incidents of mortgage application misrepresentation can be found nationwide. However, they tend to have their greatest concentrations in selected geographic areas. We have classified several locales using the following categories:

- **RED ZONE** -- Substantial numbers of incidents have been submitted to MARI's MIDEX database for three or more consecutive years.
- **ORANGE ZONE** -- Significant numbers of incidents have been reported to MIDEX over the last one to three years.
- **YELLOW ZONE** -- The number of reported incidents may be small but is growing and/or anecdotal reports and evidence received from MIDEX subscribers indicate increasing problems.

The table below shows a classification of various geographical areas according to these color codes.

GEOGRAPHIC HOT SPOTS
RED ZONE:
California: Especially Orange & Riverside Counties
Florida: Especially South Florida
ORANGE ZONE:
New York/New Jersey
Mid-Atlantic: Washington, D.C., Northern Virginia & Maryland
Chicago Area
YELLOW ZONE:
Intermountain: Denver, Las Vegas, Salt Lake City, Phoenix & Albuquerque
Northwest: Washington & Oregon

California and Florida are grouped together in the RED zone; however, they are not identical. California has clearly led the nation in the number of incidents reported to MARI's MIDEX system for many years. Florida lags significantly behind California, but it is still substantially ahead of any areas in the ORANGE zone.

The ORANGE zone locations are all somewhat similar in their activity levels. They do not have the stark disparity of California and Florida.

Those geographic areas assigned to the YELLOW zone tend to be somewhat less populous and have not yet generated large numbers of incidents. However, the short-term trend of reports received by MARI indicates that lenders active in these areas should be alert to potential problems.

Most Vulnerable Documents

Subscribers reporting incidents of misrepresentation to the MIDEX system list all the problems they have found in loan files containing misrepresented information. Typically, a loan with misrepresentation has multiple problems. The table below shows a breakdown of the problem documents or types of information reported in the MIDEX database. The incidents generating these problems occurred, for the most part, between 1990 and the end of 1998.

Cumulative Problems Reported to MIDEX	As of 12/31/98
Application Information	73%
VOEs	44%
Tax Returns & Financial Statements	37%
VODs	25%
Escrow/Closing	25%
Appraisal/Valuation	5%
Credit History	5%

The table above shows seven different types of general problems. The Application Information problems include misrepresentations for employment history, income, missing debt, and occupancy status. VOEs were misrepresented primarily through completely fabricated VOE documents. Another example of a VOE problem is forged signatures on documents. Tax and Financial Statements problems consisted of fabricated returns and altered or forged backup documents. VOD misrepresentations were made up primarily of fabricated VOD documents. Falsified gift letters, altered or incorrect deposit figures, and forgeries were also found. Escrow and Closing misrepresentations included falsified or incorrect down payment information.

Single Biggest Problem: Complete Fabrications

The MIDEX reports detailing these problems show the impact of technology on the types of information backing up loan applications. The most commonly cited problem with the documentation described in MIDEX reports is “completely fabricated _____.” The blank can be filled with virtually any backup document. Desktop publishing allows creative, interested parties the option of producing documents that, in many cases, are hard to distinguish from the real thing. In addition, automated tax preparation programs allow certain parties to create credible-looking, but fraudulent tax returns for self-employed borrowers.

The most notable characteristic of the table above is that the figures total more than 100%. This is due to the fact that the typical misrepresented loan application package includes multiple problems.

An apparent anomaly in this table is the low level of reported Appraisal and Valuation problems. Many observers of the mortgage field believe that far more than 5% of misrepresented loan files involve valuation issues.

The reason for this low result, however, is explained by the fact that most incidents reported to the MIDEX database contain multiple problems. Thus, the loan in question is usually classified as containing misrepresentation; the application is rejected; a repurchase demand is made; or mortgage insurance coverage is rescinded for a number of reasons. Even if the owner or insurer of the loan suspects the appraisal is misrepresented, there is often no need to spend scarce resources on a new or review appraisal when other conditions justify taking adverse action. Therefore, investigations of problem files often do not reach the stage where improper appraisals are documented with sufficient certainty to justify their being reported.

Is There Anything New In Mortgage Fraud?

The table presented below shows the types of problems reported in the previous table broken out by year for the past five years.

Problem Type by Year²	'94 & Earlier	'95	'96	'97	'98
Application Information	71%	80%	72%	74%	71%
VOEs	45%	48%	41%	41%	47%
Tax Returns & Financial Statements	39%	35%	35%	36%	40%
VODs	28%	28%	21%	19%	32%
Escrow/Closing	26%	32%	23%	15%	25%
Appraisal/Valuation	7%	5%	4%	4%	5%
Credit History	4%	4%	4%	12%	9%

The most striking result in this table is the relative stability of the problem types over the past five years. There are occasional blips in the figures, but

- The rankings of the problem types remains substantially constant; and
- The relative magnitudes of each problem area's figures are quite stable year after year.

There were slight increases in the occurrences of certain types of problems in 1998, but the changes noted are not sufficiently significant to warrant alarms at this time.

² Each column of this table represents incidents associated with loans originated in the designated year. For instance, 71% of the incidents reported to MIDEX for loans originated in 1998 contained misrepresented Application Information. The '94 numbers refer to all MIDEX incidents reported for loans originated in 1994 and earlier. In addition, all the numbers in this table are dynamic and subject to change in the future. This is due to the fact that in 1999, some subscribers will find and report misrepresentation in loans they originated back in 1995, 1996, etc.

LoanWatch Results

Multiple Applications and Fraud Alerts

Approximately one million loans were processed through the LoanWatch system for all of 1998.

However, the results discussed in this report refer to loans processed during the last six months of the year. This is a period MARI believes is most reflective of the results we may expect after the beginning of year 2000. This is also a period when the system was in stable operation without major changes in the subscription group.

Some caution is appropriate when interpreting these results. Since LoanWatch operates on the basis of multiple applications and since less than 100% of industry members use the system, some of the results may be strongly influenced by the market overlap of the participating subscribers. They should not necessarily be interpreted as reflecting results one might see once most of the mortgage lending community participates.

Wasted Effort: Processing Too Many Multiple Applications

Despite less than 100% participation from the industry, LoanWatch found 4.6% of the loans it processed in the last half of 1998 had matching loans within the system. These matches were evenly split between loans where there was simply another application or rate lock and those where the information contained in the matching applications was inconsistent.

States Where Lenders See Double

The LoanWatch table contained in Appendix B of this report shows how each state rated in terms of multiple applications. The total matches ranged from a high of 7.9% in California to a low of 0% in North Dakota. Appendix B breaks out the percentages of loan applications with application/lock matches for each state as well as the potential fraud matches due to the existence of inconsistencies between two or more matching loans.

For some states (like North Dakota), the percentages may be based on relatively small numbers. However, the following table shows the top ten states where LoanWatch found multiple applications/locks and potential inconsistencies.

LoanWatch Geographic Distributions		
Rank	Multiple Applications/Locks	Potential Inconsistencies
1	Utah	Alaska
2	New Mexico	California
3	California	Arizona
4	Oklahoma	Georgia
5	Michigan	Colorado
6	Illinois	Washington
7	Washington	Maine
8	Colorado	Nevada
9	District of Columbia	Oregon
10	Maryland	Michigan

Three Kinds of Trouble

The potential inconsistencies found by LoanWatch are classified into three categories. These categories, together with examples of the situations that could raise concern, are discussed below.

1. **Occupancy:** a borrower may be applying for loans on two different properties and designating both as owner-occupied; or the borrower may have two loan applications for the same property indicating owner-occupied for one and investment for the other.
2. **Multiple Transactions:** a borrower may be processing loans for multiple properties simultaneously; or the same property may be involved in multiple transactions within a very short period of time (flips and churning).
3. **Undisclosed Liabilities:** a borrower simultaneously processing a refinance application and a second mortgage loan application with different lenders may not have disclosed the other pending liability to each lender. The same may be true for borrowers processing loans on separate properties with different lenders at the same time.

For the second half of 1998, the distribution of these potential problems found in LoanWatch was as follows:

Potential Problems Found by LoanWatch	
Problem Type	% Loans with Problems
Occupancy Discrepancies	33%
Multiple Transactions	55%
Potential Undisclosed Liabilities	52%

The fact that the figures shown in the previous table add to more than 100% results from the fact that many loan applications potentially have multiple problems.

Again, however, these figures should be interpreted with a certain amount of caution. Some of the information in these data results from the overlap of the loan processing pipelines of current subscribers. A more representative picture of the problems found in multiple loan applications will be available when more companies in the mortgage industry contribute information.

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