P&G Banking

ADVISOR

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Combating mortgage fraud

P&G Associates

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Combating mortgage fraud

Mortgage fraud is among the fastest growing white-collar crimes in the United States. According to the Financial Crimes Enforcement Network, the number of Suspicious Activity Reports (SARs) reporting mortgage fraud ballooned from around 3,500 in 2000 to nearly 65,000 in 2008. And the first six months of 2009 were on pace with 2008, according to the latest information available from *The SAR Activity Review* (January 2010).

Preventing and detecting mortgage fraud may seem like a daunting task. But while there's no foolproof method for fending off fraudsters, it's critical for your bank to have an antifraud program. A solid program will help you: 1) deter fraud, 2) detect fraud early so you can respond quickly, and 3) satisfy regulators that any frauds that do occur aren't the result of a systemic failure.

Fraud school

One of the most important things you can do to combat mortgage fraud is to teach employees to understand the mechanics of common fraud schemes and to recognize the red flags. A good place to start is by reading the FFIEC's February 2010 report, "The Detection and Deterrence of Mortgage Fraud Against Financial Institutions: A White Paper."

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The 97-page report provides a comprehensive look at mortgage fraud and outlines best practices for preventing fraud and red flags for detecting it. The report details older fraud schemes as well as newer ones and describes the most common *mechanisms* used to perpetrate these schemes, including asset "rental," fake down payments, fraudulent appraisals and documentation, and identity theft.

Buy and bail schemes

One fairly new scheme is called "buy and bail." Here's how it works: Suppose that Sara lives in a house she purchased in 2007 for $500,000, but its value has declined to $350,000. She's current on her adjustable rate mortgage, but she's concerned that she won't be able to afford the payments when the rate adjusts upward in a few months.

Sara finds a comparable house selling for $275,000 and obtains a loan to purchase it by falsely claiming to rent out her existing property. She moves into the new house and then defaults (or "bails") on her mortgage on the first house.

The FFIEC recommends several best practices that can help prevent this type of fraud, including reviewing the borrower's credit report for recent deficiencies, verifying rental agreements and evaluating the reasonableness of rental cash flows. Red flags that may indicate a buy and bail scheme include second homes with substantially lower values or loan amounts, borrowers with minimal or no equity, purported tenants who have a pre-existing relationship with the borrower, and borrowers who default on the original mortgage shortly after purchasing a second property.

Best practices

The FFIEC report contains a comprehensive list of best practices and red flags on a scheme-by-scheme and mechanism-by-mechanism basis. Best practices that are common to many fraud schemes and mechanisms include establishing an employee training program and providing employees with regular fraud updates.

Your bank also should establish prudent customer due diligence and identification procedures, scrutinize borrowers' financial information for unusual items or trends, establish independent verification procedures to ensure the accuracy of submitted information, and conduct prefunding and postclosing reviews to look for inconsistencies. Other core best practices include:

- Surprise visits to business locations;
- Physical verification of selected properties and comparables;
- Sound appraisal management and review processes and monitoring appraisers for suspensions, terminations or enforcement actions;
- Verification that prior liens are paid immediately from new loan proceeds;
- Using original supporting documentation when possible;
- Conducting risk-based quality control audits before funding;
- Periodic independent audits of loan operations; and
- Fraud hotlines for anonymous tips.

The appropriate best practices depend on factors such as your bank's size, location, product and service offerings, and risk profile.

Get with the program

Mortgage fraud is a costly problem for banks, and it's likely to get worse. To minimize your bank's losses, be sure you have a plan for preventing, detecting and mitigating it. ▲

Going paperless? Take time to plan

The term "paperless" encompasses a number of different technologies, from remote deposit capture and online loan applications to back-office document management systems. More and more community banks are considering implementing the latter as imaging costs decrease.

Count the benefits

Reasons to develop a document management system span a bank's operations. Here are seven potential benefits:

1. Reduced storage, printing and shipping costs. By scanning documents and storing them electronically, you can substantially reduce the amount of space your bank needs for storing paper files. And by transmitting documents electronically you avoid printing and shipping costs.

2. Greater efficiency. Employees can retrieve important documents quickly from a central server instead of waiting for someone to sift through paper files, which may be stored elsewhere in the bank or even at a separate branch or office.

3. Better customer service. The ability to call up account- and loan-related documents in a matter of seconds can help boost customer satisfaction.

4. Lowered audit costs. Document management systems reduce expenses associated with bringing in outside loan auditors because you can send auditors a CD or DVD containing images of loan documents.

5. Improved compliance. Intelligent document management (iDM) systems can help banks comply with complex federal and state regulatory requirements by automating processes such as loan document preparation. For example, an iDM system can be programmed to select the necessary loan documents to meet applicable compliance requirements. It also can streamline the loan application process, which reduces costs and improves customer service.

6. Fewer mistakes. Good document management systems create an electronic "paper trail," employing time stamps and revision controls to ensure that your employees are using the right version of a document. They also make it much harder to accidentally shred an important document.

7. Beefed up security. A properly designed document management system improves security by eliminating physical files and avoiding the need to mail or ship documents.

In today's challenging banking environment, these benefits are significant. And as document management technology becomes increasingly affordable, more and more banks are finding that the benefits definitely justify the costs.

Be sure your plan covers key steps such as requirement analysis, hardware and software analysis, vendor due diligence, installation, testing and support.

Fashion a plan

Too often, banks jump into document management projects unprepared. If you start scanning documents without a well-thought-out plan, you're not only asking for trouble, but also inviting unnecessary costs and headaches. Here are some tips for implementing a document management system at your bank:

Put your plan in writing. Be sure it covers key steps such as requirement analysis, hardware and software analysis, vendor due diligence, installation, testing, training and support.

Decide up front which documents to convert into digital format. Some banks adopt an "on-demand" approach, in which documents are scanned and digitized as they're requested. Another strategy is to convert key documents up front and use an on-demand approach for other documents.

Create an indexing system. Without a carefully designed indexing system, electronic files will be even more difficult to locate than the paper ones they replaced. By understanding the different types of documents your system will store and creating appropriate indexing procedures, you'll enable employees to quickly find the documents they need. Also, consider whether you should run scanned images through optical character recognition software to allow for full-text keyword searching.

Review current systems. Before you select a document management solution, take a look at your current workflow management systems to be sure they can be integrated smoothly with your document management system.

A win-win situation

Thorough planning can help ensure that a document management system meets your objectives. Your bank can avoid unnecessary costs as it becomes more efficient. And your customers are likely to find it easier to access their — better protected — information. ▲

Guard your system if outsourcing

Outside consultants can be invaluable in implementing a document management system and can even help with the document scanning process. If you outsource this work, however, be sure that you comply with financial privacy regulations, which require your bank to take steps to protect customer information.

This means exercising due diligence when selecting service providers, contractually requiring them to implement appropriate information security and monitoring their activities. Bank oversight is particularly important for third-party providers involved in document management because they have access to confidential customer information. Among other things, your bank should regularly monitor the provider's financial condition and internal controls, and assess the quality of its service and support.

Telltale trouble

How to assess if a customer will fail

The economy is on the mend, but businesses of all kinds continue to shut their doors. To protect your bank from being left holding the proverbial bag, you need to identify borrowers that can't turn themselves around. Spotting borrowers that have likely reached the point of no return — vs. those able to rebound — can be accomplished if you diligently search for warning signs.

Recognizing severity

Universal warning signs recognized by lenders include problems with working capital, operating cash flow, credit lines and collateral values. These problems may be severe — or not.

For example, a working capital problem involving one large bill that's 60 days outstanding due to an invoicing mistake is probably collectible. But several invoices that are over 120 days are probably not. The first scenario is something a customer likely could overcome, although the company might temporarily max out its line of credit. The second scenario looks like a critical situation that, if severe enough, could foretell a bankruptcy.

Minor problems materialize as, say, a few late bills, occasional cash overdrafts or subtle changes in gross margin on financial statements. But *irreparable* damages show up as payables over 90 days old, vendor demands for cash on delivery, unpaid payroll and recurring net losses.

Answering wake-up calls

Because most borrowers prepare only annual financial statements, the numbers often reveal too little, too late. To avoid financial statement surprises at year end, consider asking borrowers to submit monthly or quarterly reports. Strong borrowers likely will comply, but weaker ones may have something to hide and resist your request.

Other wake-up calls are missed loan payments, lapsed insurance coverage and late financial statements. For closely held companies, keep an eye on personal credit card accounts that might be tapped to fund corporate cash shortfalls. A qualified audit opinion — when the auditor disagrees with the treatment or disclosure of information in the financial statements — also is cause for alarm.

Spotting non-numeric red flags

Also keep your eyes open for the non-numeric indicators of distress. For example, when you visit a retailer, do its stores appear understocked or understaffed? Does the borrower fail to return phone calls? Are leasehold improvements and signage up-to-date? Does the company advertise liquidation sales or steep discounts?

Other telltale signs of impending bankruptcy include heavy layoffs and high turnover among employees, especially key managers and directors. These insiders often see the writing on the wall, and then make tracks for greener pastures. Major events — such as technological innovations by your customers' competitors, uninsured losses or the bankruptcy of a major customer — also can have devastating effects on future operations.

Unveiling inside problems

Recession is an external factor that interrupts business operations. But irreparable financial distress often is rooted in *internal* problems. For example, poor management can be a leading indicator of financial distress. Watch out for gridlock among owners, lack of management depth, frivolous spending habits and personal problems, such as contentious divorces or gambling addictions.

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The key to recovery is conceding that there *is* a problem. Distressed business owners must be able to ditch denial and implement stopgap measures, such as selling off underused equipment, liquidating inventory, asking employees to forgo raises and bonuses, renegotiating debt terms and converting fixed costs to variable.

Pinpointing strengths

An established track record is the best indicator of management strength. Investigate how a company performed during the 1992 and 2001 downturns. Then consider how market conditions have changed since the previous downturns. Of course, startups and new management teams require additional oversight to ensure continued viability.

Strong managers focus on core operations; veering off course, especially during a recession, can prove disastrous. Management also should know how to anticipate cash flow needs and to build a cash safety net in case of unforeseen events, such as a strike, a cost increase or a large warranty claim. Strong accounting systems identify which customers and products are most profitable — and which low-margin ones are disposable.

Your customers' health

Identifying strengths will help you predict which of your business-loan customers likely will emerge from the down economy in good shape. And spotting warning signs will help ensure that your bank makes the correct lending decisions, even when it means pulling the plug. ▲

BANK

Wire

TAG EXTENDS TO 2011

The FDIC has extended its Transaction Account Guarantee (TAG) program through Dec. 31, 2010. The program had been set to expire at the end of June.

TAG provides depositors with unlimited coverage for noninterest-bearing transaction accounts — such as demand deposit accounts and other accounts that allow unlimited withdrawals and can't earn interest. The TAG assessment reporting will be based on average daily account balances. And the FDIC reduced the maximum rate that can be paid for qualifying NOW accounts to 0.25% from 0.50%. ▲

WEIGHING IN ON FUNDING, LIQUIDITY RISK

The federal banking agencies recently issued joint guidance on identifying, measuring, monitoring, and controlling their funding and liquidity risks. The guidance re-emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan.

The agencies issued the guidance on March 17. See Letter SR 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," at www.federalreserve.gov/boarddocs/srletters. ▲

BANKERS ON OVERDRAFT FEES

Amendments to Regulation E now require customers to opt in to overdraft programs that assess a fee for ATM or one-time debit card transactions when there are insufficient funds in the account. A survey conducted by the Financial Managers Society on April 13, before the new requirement's July 1 effective date, asked financial institutions how they planned to respond.

More than 75% of respondents said they already offered a courtesy pay program for ATM and/or debit transactions that includes overdraft fees. Of those, 94% said they would continue their programs after the new rules took effect, and the majority (86% for debit transactions and 85% for ATM transactions) said they wouldn't change their (corresponding) fees. ▲

OVERTIME PAY FOR MORTGAGE LENDERS

In a reversal of its previous opinion, the U.S. Department of Labor on March 24 issued Administrator's Interpretation No. 2010-1, concluding that typical mortgage loan officers aren't exempt from overtime requirements, as administrative employees are. As a result, banks should carefully review the job descriptions of their mortgage loan officers and employees who perform similar duties to be sure they're classified properly. ▲

UBPR MODERNIZED

The federal banking agencies have modernized the Uniform Bank Performance Report (UBPR), allowing for faster, more accurate delivery, more frequent updates and other enhancements. In addition to providing expanded content, the modernized system uses eXtensible Business Reporting Language to deliver bank financial information in a format that's easier for banks to download and manipulate. ▲

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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