Detection and Prevention of Mortgage Loan Fraud

by Vernon Martin

The past 10 years have been among the best for real estate investment, causing many lenders to let their guard down in originating mortgage loans. Mortgage fraud is much more common than most lenders know, and most of it will not become evident until the next downturn in the real estate cycle—a downturn that already has begun in many commercial real estate markets. This short primer offers advice to lenders and appraisers on how to spot and prevent a variety of common mortgage frauds.

"It's only when the tide goes out that you learn who's been swimming naked."

—Warren Buffett

Odd as it sounds, residential and commercial mortgage fraud can be *obvious* or *hidden*. Of the two, it's *hidden* fraud that is a ticking time bomb in today's mortgage loan portfolios, as defaults will not necessarily occur until interest rates rise or short-term loans mature. And, as we all know, interest rates are now on the rise.

Hidden fraud has become more prevalent with today's predominance of third-party loan originators (brokers and conduit lenders). These originators rarely operate with the internal control structures of regulated banks and thrift institutions and are more likely to fall prey to or commit fraud. Many mortgage brokers are independently employed and merely originate loans without worrying about the consequences of bad loans.

Even bank-based loan originators may bypass proper due diligence if they are paid wholly or in part by commissions based on loan volume. This should come as no surprise, but it's after a "boom" market that the biggest lending mistakes are made. Lending institutions have not necessarily lowered their standards in the current market, but the escalating variety of mortgage frauds compounds the problem.

© 2004 by RMA. *Vernon Martin is the western region review appraiser for an East Coast investment bank and was previously vice president for Appraisal Review for Home Savings of America and chief commercial appraiser at IndyMac Bank. He teaches real estate valuation at California State University, Los Angeles, and has published articles on banking and real estate subjects in such publications as* Banking Law Journal, The Appraisal Journal, Real Estate Review, Mortgage Banking, *and* Fraud Magazine.

Degrees of Fraudulent Intent

Obvious fraud: fraud for profit. Three men claiming to be doctors purchased a New York City walk-up apartment building on a residential street. They then applied at the nation's largest thrift institution for a much larger cash-out refinance loan, with the stated purpose of converting the ground floor into a magnetic resonance imaging (MRI) facility. MRI space would command a much higher rent than was currently earned from the rent-controlled ground floor apartment tenants, and this was reflected in the appraisal done in-house. Once funded, the loan went into immediate default and the borrowers disappeared.

Unbeknownst to the appraiser and underwriter of this transaction, these same three "doctors" had mortgaged another property at the same lending institution on the pretext that they would be converting hard-to-lease basement space into a natural foods store. This loan also went into immediate default.

This is the type of "fraud for profit" that is associated with early payment defaults. The perpetrators disappear quickly and leave behind a property worth just a fraction of its appraised value. The lender immediately becomes aware of the problem when a representative makes a field visit to the vacant property. This unfortunate loan default could have been avoided if the appraiser or underwriter at the lending institution had checked with the City of New York to see if such a use was allowable under residential zoning and if permits had been issued for such space; the answer would have been "no" to both questions. Surprisingly, this particular institution did not have such a written policy in place. A database with borrower names as "key variables" would have alerted the institution to multiple applications from the same borrowers.

The most common fraud for profit is *property flipping*, the practice of purchasing dilapidated properties and reselling them at inflated prices to straw buyers or duped buyers. A *straw buyer* is either a phony buyer who will never occupy the property or a complicit buyer who is given a financial incentive. A *duped buyer* is an unsophisticated buyer, without cash or good credit, who is induced into purchasing a home at an inflated price with the lure of "no money down." The transaction is often supported by inflated appraisals, false verifications of income, and false verifications of deposits in order to deceive an out-of-town lender. The borrower is often overwhelmed by the debt and consequently defaults. A particularly insidious aspect of property flipping is that it poisons property sales databases. It presents the illusion of rising property values and deceives lenders and appraisers about value trends in the neighborhoods where the flipping takes place.

Although property flipping used to be limited to residential lending, it has now crossed over into commercial lending. In Kansas City, for example, data on apartment building sales was recently tainted by a well-publicized fraud ring that organized limited partnerships to purchase apartment properties at inflated prices, skim the revenues, and then default on the loans.

Hidden fraud: fraud for loans. Other types of mortgage fraud are much more common, but far less obvious. The intention here is to repay the lender if the property's value and performance (as an income property) increase, but to default if the property's performance and value decrease, leaving the lender holding the bag. Such frauds usually either mislead or corrupt a real estate appraiser into tricking the lender into lending more money than is adequately secured by the property and its cash flow, while also minimizing the risk of equity loss to the borrower, who may not even have any actual equity in the deal.

Payment defaults in such a hidden fraud occur a year or years after the loan's origination, and lenders usually do not think to look backward in time for fraud at the time of loan origination. This type of fraud is increasing now that more commercial properties are experiencing declining performance. Borrowers know they are in trouble long before would-be lenders do, and mortgage fraud is used by the borrower to mitigate risk and minimize equity investment.

So far, the low cost of debt has controlled the rate of default on these loans. When debt is at a low fixed rate, the day of reckoning can be postponed for a long time. Frauds with problem assets financed by floating-rate debt or loans with short maturities may surface more rapidly as interest rates rise.

A LENDING INSTITUTION SHOULD ALWAYS HAVE ITS APPRAISERS AND UNDERWRITERS COMPARE THE SALES LISTING WITH THE PURCHASE CONTRACT AND EXAMINE THE PURCHASE CONTRACT FOR RED FLAGS.

Common Deceptions

During my 19 years of reviewing appraisal reports and performing due diligence, I've identified several common deceptions as well as measures that can prevent such frauds. Most examples were caught in time to stop the fraud, but some (unfortunately) are from postmortem analysis.

Deceptive purchase contracts and hidden seller concessions. Because so many appraisers and lenders think of the purchase price as *prima facie* evidence of market value, it has become quite common to see deceptive purchase agreements that inflate contract purchase prices. This is done with hidden or stated concessions, such as seller financing and allowances for repair.

Here is how it might work:

A borrower wants to purchase a home for $200,000 with no cash down payment. If the lender's maximum loan-to-value ratio is 80% and the property is appraised for $200,000, the borrower is out of luck, as is the loan agent or broker. However, the problem is solved if the seller and buyer revise the purchase contract to *$250,000*; then the buyer finances $40,000 through the seller in a second mortgage agreement (contained in a conveniently missing addendum) that the seller agrees to rip up after closing the loan; and then the seller agrees to refund the remaining $10,000 cash down payment (contained in another conveniently missing addendum). The buyer gets a house with "no money down," the seller gets full asking price, and the real estate and loan brokers get commissions based on the inflated purchase price and loan amount. Many residential lenders today do not supply appraisers with purchase contracts, rationalizing it would take too long to do so, and the appraiser may be fooled into believing that the $250,000 price is a bona fide purchase price.

Commentary on the Appraisal Institute's *AIForum*, an on-line forum for appraisers, suggests that many lending institutions currently pressure the appraiser to hit the sale price of the home, with the effect being that appraisers generally tend to rubber-stamp the stated purchase price approximately 98% of the time. Most mortgage brokers know this, too, and many intimidate appraisers into hitting these target values to make the deals work. This is a widely known secret in the mortgage business and the subject of many letters to congressmen by appraisers and their professional associations. *AIForum* has daily examples of such pressure and malfeasance.

Deceptive purchase agreements are now common in the commercial arena, too. An example I witnessed last year was a loan application for a purchase at $3.2 million of a Houston office building still listed on LoopNet (a commercial real estate listing Web site) for $2.35 million.

To avoid being fooled, a lending institution should always have its appraisers and underwriters compare the sales listing with the purchase contract and examine the purchase contract for red flags, including:

1. Seller financing. It is possible that such a loan could be "forgivable," particularly if there is a relationship between the seller and buyer.
2. Allowances for repairs. If the repairs are not yet started, this amount should be deducted from the purchase price. All repairs should be verified by inspection before being assigned value.
3. Comparison of the buyer and seller. If they are individuals, do they share a surname? If the buyer or seller is a limited partnership, there should be some research on the principals. Know your client, and know whether one or more of the principals is on the opposite side of the transaction.

Most of all, appraisers should not be harassed by the lender for failing to appraise a property for its purchase price. In a refinance application last year, an appraiser valued an apartment property in Oklahoma for $1.575 million, with the understanding that the purchase price several months previously had been $1.4 million and

occupancy had increased from 50% to 97%. The previous closing statement indicated that the seller had provided a $350,000 allowance for repairs (equal to $6,000 per unit) and $50,000 in seller financing with undisclosed terms. An inspection of the property yielded no evidence that $350,000 had been spent on renovation, as all units still had original appliances and carpets from the early 1970s. As for the 97% occupancy, this was being achieved with low tenant quality—so low that 55% of the new tenants had been evicted before their six-month leases had expired. An independent local real estate broker stated that he and his peers were already aware that this property had been effectively purchased for $1 million, but the appraiser was nevertheless unduly influenced by the misrepresentation of the effective purchase price.

The "pocket-to-pocket" lease. A renovated, century-old warehouse building on a dirt road near the Denver central business district was appraised as a fully occupied, class-A downtown office building. A knowledgeable broker informed me that the owner had signed a high-rent lease to an entity he controlled to make the building appear fully leased at high rents. The owner's space seemed to be vacant. The appraiser relied on this lease for occupancy and market rent information to arrive at a value estimate of $4.25 million. The building was subsequently valued at $1.55 million seven months after the original appraisal, based on market rents for such space. A lending institution's appraisal policy should call for a property to be appraised at market rents if contract rents seem too high. In addition, any above-market lease in which the tenant has not yet moved into the space should be viewed quite skeptically.

A LENDING INSTITUTION'S APPRAISAL POLICY SHOULD CALL FOR A PROPERTY TO BE APPRAISED AT MARKET RENTS IF CONTRACT RENTS SEEM TOO HIGH. IN ADDITION, ANY ABOVE-MARKET LEASE IN WHICH THE TENANT HAS NOT YET MOVED INTO THE SPACE SHOULD BE VIEWED QUITE SKEPTICALLY.

Bogus construction plans. As another example, a real estate developer wished to acquire and hold a piece of land on which he would eventually build an industrial park. The developer admitted in a newspaper interview that he would use the site for airport parking until such time that industrial park development became feasible again. Wishing to purchase the land for $24 million, he persuaded a bank to lend $30 million to build a permanent, state-of-the-art airport parking lot, with ground leases to McDonalds, Denny's, Hertz, Budget Rent-a-Car, Chevron, and a national taco chain. Colluding with an inside loan officer, he obtained an appraisal that was made to order, valuing the completed parking lot at more than $67 million. The appraisal assumed parking rates of $14 to $20 per day in a market where most daily rates were $9, even though the proposed lot would increase parking inventory by more than 40% at an airport already at maximum legal flight capacity. Although the parking lot was completed, none of the ground leases were executed. Because the oversupply of parking created a price war, daily rates at this parking lot are now only $7 uncovered to $10 covered, and the property is presumably operating at a loss after debt service on a $30 million loan. This loan was then sold to other financial institutions under the misrepresentation that the airport itself planned to lease the parking lot, although the airport had been suing the developer for two years and had erected a fence around the parking lot to prevent pedestrian access to terminals.

This $30 million loan fraud could have been prevented with the following policies:

1. Commissioned loan agents should not be allowed to order appraisals. A noncommissioned party, such as a chief appraiser or chief credit officer, should do the ordering.
2. The bank should have insisted that only appraisers from its approved list be used. This appraiser was not approved and was also linked to a $225 million loan default at another institution.
3. The date of the inspection, the date of the appraisal order, and the date of the report should be compared. In this case, the inspection had been performed before

A LENDING INSTITUTION SHOULD INSTRUCT ITS APPRAISERS AND UNDERWRITERS TO IGNORE OFFERS AND EXPIRED SALES CONTRACTS FOR REFINANCE TRANSACTIONS.

the appraisal was ordered, suggesting that the appraisal had already been done for another party, possibly the developer. Also suspect ws the delivery of the appraisal of such a complex property only one week after it had been ordered. Most commercial appraisals of for less complicated properties arrive in three to four weeks.

Bogus offers to lease. Nothing substitutes for signed leases with real tenants. Letters of intent are generally nonbinding, and to be assigned any credibility they should come from recognized credit tenants on company letterhead. Despite these intuitively obvious precautions, a vacant former Costco warehouse was purchased for $1.62 million in 2001 and was appraised one year later for $21.5 million, resulting in a $14 million funded loan, with the assumption that Federal Express, Walgreens, AutoZone, El Pollo Loco, and Global Terratransit would be leasing it, although there was no documented interest from any of these tenants. Federal Express, which was to occupy 40% of the space, had chosen a nearby building instead. Two years later, the only tenant is an ethnic supermarket. A lending institution's appraisal policy should insist the property be valued based on market rents, market vacancy rates, and market absorption rates until a bona fide lease can be produced.

Bogus offers to purchase. One of the oldest and most transparent scams is to provide oral or written "offers to purchase" in applications for refinance at unjustifiably high amounts. These obviously cannot be accepted as bona fide indicators of market value. A recent loan applicant claimed an offer to purchase his 11-unit apartment property in a low-income neighborhood for $1.8 million, when similarly sized properties were trading at $750,000 to $800,000.

Owners of a 33-year-old apartment building in El Centro, California, a low-income desert community, applied for refinancing and supplied two expired sales contracts—the first for $2.3 million and the second for $2.6 million—from five months before. They claimed scheduled rents well above market rents. All of the comparable sales located in El Centro were more modern buildings and had sold in the range of $33,000 to $38,000 per unit, which would indicate a value for the subject of $1.4 million to $1.6 million, but the appraiser relied on these expired sales contracts and above-market rents to estimate value at $2.5 million.

A lending institution should instruct its appraisers and underwriters to ignore offers and expired sales contracts for refinance transactions.

Illegal improvements. An owner of two mixed-use buildings on Lombard Street in San Francisco applied for refinancing, demonstrating signed contracts for billboard leases on these buildings at rental rates exceeding rents from the space inside. General Motors had just signed a contract to lease the larger sign at a net rate of $32,000 per month, verified by a GM representative. The owner also produced permits from CalTrans (California Department of Transportation) for these signs, as Lombard Street is part of Highway 101, a California state highway. Nevertheless, there was no historical record of sign rental income prior to the summer of 2003. A fortuitous phone call to San Francisco's Planning Enforcement Department indicated that the signs were erected without permits from the city and a letter to the owner was being sent out that same day with an order to remove the signs. A permit from CalTrans does not negate the need for a permit from the city of San Francisco, which strictly regulates and limits billboard advertising. The point of this example is that income from illegally erected improvements cannot necessarily be considered permanent income, particularly in communities with reputations for vigorous code enforcement.

Extraordinary appraisal assumptions. It is comforting to see that appraisers are now prominently disclosing "extraordinary assumptions" in their reports rather than burying them in the "assumptions and limiting condi-

tions" section as in years past. This new trend is also a cryptic cry for help: "Look at what the loan salesperson is making me do!"

A recent example is the appraisal of a proposed subdivision outside Sacramento, California, in which the appraiser was asked to assume the existence of a street providing access to the proposed subdivision when no such street existed. His "as-is value assuming completion of the street at no expense to the developer" would appear ludicrous to any review appraiser, but was seen as credible by a chief lending officer. There is only one definition of "as is," and it is "as is." Banks should reject "hypothetical appraisals" or appraisals containing "extraordinary assumptions" of conditions that do not exist or cannot reasonably be expected to exist.

Assumptions also relate to proposed market conditions. One of the most misused extraordinary assumptions of the 1980s was that of sufficient demand for the proposed improvements. As a result, the Texas prairies were bejeweled with empty office buildings.

From a lending viewpoint, one must be very careful with appraisal reports using the catchphrase "per client's instructions." While this could be the hallmark of a conservative lender wary of inflated pro formas, it also could be a warning of possible manipulation by self-interested parties, such as commissioned loan agents. Assumptions dictated by commissioned loan agents can have major effects on value estimates.

It's essential to carefully review the Assumptions and

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Limiting Conditions section of the appraisal report. The following unreasonable assumptions were presented by Office of Thrift Supervision examiner Glen Sanders in a 1989 speech to the National Association of Review Appraisers:

- Assuming the site will be rezoned.
- Assuming undeveloped land has utilities.
- Assuming there is effective demand for the proposed development.
- Assuming there will be 95% occupancy.
- Assuming the land is stable.
- Assuming the land has valuable oil assets beneath it.
- Assuming the client's statements are correct.

The last statement is a common appraiser's cop-out. The lender should instruct the appraiser to alert it to any borrower dishonesty immediately.

Another extraordinary assumption seen in appraisals of environmentally contaminated sites is the assumption that contaminated land is not contaminated. It behooves lenders to supply appraisers with relevant environmental reports for the properties being appraised.

Misrepresented or undisclosed property conditions. The most important policy for a lending institution is to have a noncommissioned representative make a field inspection of the property designated as collateral for the loan. At one bank, a field inspection by a newly hired chief appraiser found that a subdivision in the Sacramento area was represented as 80% complete by an appraiser hired by a loan salesman and corroborated by two loan salesmen; in fact, it had only been rough-graded and appeared to be only 15% complete at best.

In another instance, a loan broker did not disclose that the borrower's trailer park was an unremediated Superfund site. A bank representative can ascertain Superfund status at www.epa.gov/superfund.

The borrower cannot be expected to disclose tax liens and special assessments, and many lenders today are not sufficiently disciplined about providing preliminary title reports to appraisers. A bank recently took a $2 million loss on an incomplete subdivision in Utah for which special assessments were not disclosed to the appraiser (who was not provided a title report). The loan officer had already taken his commission and left the bank. It should be bank policy to provide a preliminary title report to the appraiser.

Some homebuilders are

BANK APPRAISAL POLICY SHOULD REQUIRE APPRAISERS TO INVESTIGATE THE OPERATING HISTORY OF THE PROPERTY AND TRY TO EXPLAIN ANY UNUSUAL CHANGES IN OCCUPANCY.

applying for refinancing on homes they have supposedly been completed on the outskirts of many secondary western cities, such as Albuquerque, Phoenix, Boise, Provo, and Anchorage, with appraisers instructed to appraise the houses as complete even when they are not. Considering that the builder's main goal is to sell homes, a refinance application from a builder only spells trouble in selling his or her product.

In situations like these, appraisers and lenders should throw away the comparable sales data and look at listings instead. An in-depth review of a builder refinance application in Provo, for instance, revealed 253 listings of similar new homes in the same zip code, listed at or below the appraised value.

Borrower-provided comparable sales data. On the residential side, borrower-provided comparable sales data is a favorite technique for property flippers and those who aid them. Appraisers do not typically need instruction in how to do their jobs, so insistent offers of free data should be viewed suspiciously as attempts to influence an appraisal assignment.

If an appraiser's comparable sales data search fails to provide other independent comparable sales, rigorous verification of the borrower's data is essential. Also, the parties in the comparable transaction need to be unrelated and the transaction closed with necessary cash equivalency adjustments to the sale price. Developers have fooled appraisers before with "pending sales" that turn out to be "offer" letters written by their relatives or friends.

False operating statements. The owner of a strip center/self-storage facility in Texas supplied deceptive operating statements that included "capital infusions" as actual income and double-counted CAM (common area maintenance) reimbursements in "base rents" and also as a separate line item of income. An unusually high percentage of revenues came from late fees, too, calling into question whether the fees were actually being collected. As a result of this deception, actual NOI had been inflated from $67,000 to $178,500. The center was in contract to be purchased by an illiterate immigrant for $1.7 million at a stated cap rate of 10.5%.

Client operating statements should not be taken at face value, but be compared for reasonableness to operating data for similar properties. Various national publications summarize revenues and expenses by reporting members, including those published by IREM (Institute for Real Estate Management), BOMA (Building Owners and Managers Association), and ICSC (International Council of Shopping Centers). Nevertheless, tax returns (Schedule E for individuals) are the preferred method for verifying revenues and expenses (be sure to exclude interest and depreciation expenses).

Sometimes, tax returns can be forgeries. A Chicago motel owner, for instance, submitted Illinois motel tax returns that understated tax liabilities by 77%. Canceled checks are one way of verifying which tax payments were really made, and this loan applicant declined to provide them. Actual tax evasion, however, opens up the worse possibility of a tax lien on the property for the amount of all evaded taxes and associated penalties. As motel taxes are often greater than 10% of revenues, this can create substantial loss for both borrower and lender.

Straw tenants. Keep in mind that occupancy can be manipulated by special concessions, and this most often occurs in the multifamily sector. Recall the previous example of the Oklahoma apartment building that went from 50% to 97% occupancy by accepting new residents with poor credit, yet had to evict 55% of the new residents.

In the early 1990s, a half-vacant apartment building in Riverside, California, was quickly leased to full occupancy by providing free-rent, no-money-down specials to high-risk tenants before being sold to an unsuspecting investor and financed with a Home Savings of America loan. As the buyer quickly discovered, many of the new residents had no intention of paying rent, and the loan went into default immediately.

Bank appraisal policy should

require appraisers to investigate the operating history of the property and try to explain any unusual changes in occupancy.

Phantom renovations. Many of today's requests for cash-out refinances contend that major renovations have occurred since the date the original loan was made, yet property inspections indicate that no work was done. This was the case with the Oklahoma apartment property described earlier.

In another instance, an appraiser estimated market rent for a rental cottage in Laguna Beach, California, at $3,125 per month. The estimate was based on representations from the borrowers that they spent $150 to $200 per square foot in renovating the cottage—renovations that did not seem evident in photographs. The appraiser was not permitted to see inside the cottage for reasons of tenant privacy. A quick check of the multiple listing service indicated that the cottage was vacant and offered for rent at $1,500 per month. Thus, lending institutions also should require appraisers to perform interior inspections. In California, an inspection is permissible with 24 hours' notice to the tenants.

A bank's property inspection policy needs to include visual verification of all stated renovations and capital improvements, but more importantly, it should be understood that not every dollar in expenditures adds a dollar of value. Swimming pools, for instance, may not add as much value as they cost to build, depending upon geographic location.

Misleading or erroneous statistics. Sellers of a nonperforming shopping center loan presented impressive trade area statistics for the shopping center, located in a blue-collar town of 7,000 residents in Michigan. Average annual household income was $72,000 within a three-mile radius and $60,000 within a one-mile radius. This seemed hard to believe when the town residents were seen washing their rusty pickup trucks across the street from this mostly vacant center, which had lost its supermarket, drugstore, and Kmart. These trade area statistics did not correspond with the 2000 census for the town, which indicated an average household income of $44,000 per year. The three-mile radius estimate of household income, if accurate, was most probably influenced by the close proximity of Gross Isle, a wealthy island suburb of Detroit, to which there were no direct roads from the subject location. The Census Bureau offers a Web site, www.census.gov, where such data can be checked for accuracy.

The pro forma. Few lenders rely on long-term income projections from borrowers, yet they will accept projections of revenues increasing at the same rate as expenses. The reality of the economic obsolescence process, however, is that expenses for nearly every commercial building will increase faster than revenues. That is why expense ratios are higher for older buildings than for newer buildings.

Witness the following comparison of operating expense ratios for garden apartments nationwide in the Institute of Real Estate Management's *2002 Income/Expense Analysis®: Conventional Apartments*:

1946-1964: 50.6%
1965-1977: 47.6%
1978-2001: 41.3%

Take the midpoint of each range, such as 1955, 1971, and 1990, to calculate respective average building ages in 2001 (when the data was collected) of 12, 30, and 46 years. Then algebraically derive a revenue growth rate that would correspond to a 5% expense inflation given these operating ratios. If a 12-year-old building was operating at a 41.3% expense ratio and expenses increased at 5% per year, use a financial calculator to solve for the revenue growth rate that would result in this building operating at an expense ratio of 47.6% 18 years later. At age 12, the building earns $100 for every $41.30 in expenses. At 5% inflation, expenses are $99.391 18 years later. Divide by 0.476, and the corresponding income would then be $208.81. Then solve for the rate of return that would turn $100 into $208.81 18 years later. The solution is a 4.17% income growth rate, not 5%. The difference may seem slight, but projecting 10 years out, the difference in income between a 4.17% growth rate and a 5% growth rate would be more than 8%, and the difference in net operating income could be twice as great or more.

Be skeptical of appraisals. Imagine the pressures put on self-employed fee appraisers. They are rarely criticized for value estimates being too high (until after foreclosure), but are often pres-

sured for value conclusions thought to be too low.

Consider the personalities of those attracted to the real estate development and sales professions; the successful ones are the equivalents of human steamrollers. By contrast, appraisers, as the old joke goes, lack the charisma it takes to be accountants (or risk management professionals). In a clash of wills, whose do you think would dominate? Physics is on the side of the loan salespeople. This has created an endemic upward bias in the appraisal profession.

It is easy for the fee appraiser to ignore or minimize negative effects on value when borrowers have snappy explanations. I have encountered numerous foreclosure situations where a property flaw, such as a lack of visibility, was obvious, yet not discounted by the appraiser. Office space without windows falls into this category, as does commercial space without road frontage. Noxious neighbors, such as dog kennels, liquor stores, and oil refineries, need to be considered in reaching a value conclusion. Traffic noise is a noxious neighbor for residential properties.

Consider if there is any relationship between the appraiser and the borrower or broker, which is often the case in small communities. Did the borrower or loan agent actually request this particular appraiser? Several years ago, in an appraisal of a failed Texas subdivision being converted into rental housing near oil refineries, the appraiser reconciled at rents and prices 50% higher than the market average while fabricating bogus comparable rentals. A review of the borrower's loan file found a résumé for the borrower indicating that he was a board member of the appraisal corporation.

Bear in mind, too, that mortgage fraud often has willing accomplices in the loan sales department of the lending institution making the loans, so the same tests of veracity should also be exercised with loan salespersons. They should not be considered the most objective sources of truth.

Conclusion

To prevent fraud, a lender must consider the possibility of bias or inaccuracy in any information submitted by interested parties and must take appropriate steps to verify the facts. The economy is now facing increases in interest rates. It is likely that as rates rise, latent frauds will be exposed. Lenders should redouble their efforts in ensuring that the controls supporting extensions of credit related to real estate should be reviewed, updated, and supported through strong compliance processes. ❒

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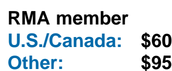

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FRAUD CHECKLIST

(Items checked Yes increase the propensity for fraud.)

PURCHASE CONTRACT	Yes	No
· Does it not include all addenda and paragraphs referenced in the document?	___	___
· Are there missing signatures?	___	___
· Is there seller financing?	___	___
· Is there reason to suspect that the buyer and seller are not related parties?	___	___
· Was the property listed at a lower price than the contract price?	___	___
· Does the contract include allowances?	___	___
BORROWER IDENTIFICATION		
· Is the SSN inconsistent with the age and location of the borrower?	___	___
· Is there a reason to believe that the borrower is related to one or more tenants?	___	___
· Does the borrower have other loan applications pending?	___	___
PROPERTY HISTORY		
· Has the property been sold recently?	___	___
· Has the property traded more than once in a small time span?	___	___
· Has the property been listed for sale for more than a year?	___	___
· Are there delinquent taxes or other liens on the property?	___	___
· Have you not checked the SuperFund status of the property?	___	___
APPRAISAL		
· Was the appraisal ordered by someone with a vested interest in the transaction?	___	___
· Is the appraiser not on your institution's approved list?	___	___
· Does the appraiser have any disciplinary actions against him or her?	___	___
· Does the appraiser's client list consist mostly of developers or brokers?	___	___
· Is there evidence that the report was done prior to being engaged by your institution?	___	___
· Has the appraiser not confirmed the borrower's statements with supporting documents?	___	___
· Is the estimate of value based on hypothetical conditions?	___	___
· Has the appraiser made extraordinary assumptions?	___	___
· Has the appraiser relied on pending sales or offers to purchase?	___	___
· Did the appraiser not analyze the preliminary title report?	___	___
· Does the appraisal include comparable sales involving the same borrower or broker?	___	___
PROPERTY CONDITION		
· Is there evidence of significant deferred maintenance?	___	___
· Are any of the improvements not covered by permits?	___	___
· Is the property not the same size as represented by the borrower or appraiser?	___	___
· Have alleged renovations not been completed?	___	___
· Are there circumstances at the property not accounted for in the appraisal?	___	___
OPERATING INFORMATION		
· Are the borrower's financial statements not supported by tax returns?	___	___
· Are the financial statements inconsistent with the leases?	___	___
· Does the borrower admit to filing false tax returns?	___	___
· Are revenues or expenses inconsistent with similar properties in the area?	___	___
· Is there unexplained "other income"?	___	___
· Have certain revenues been double counted?	___	___
· Are revenues received for services that are not normally billed?	___	___
· Have capital infusions or payments between owners been counted as income?	___	___
CONSTRUCTION		
· Did the borrower not provide plans or specifications?	___	___
· Did the borrower not provide signed leases or else LOIs on company letterhead?	___	___
· Are the proposed improvements inconsistent with the zoning of the site?	___	___
· Are there no permits for the construction?	___	___