# UNDERSTANDING THE BASICS OF MORTGAGE FRAUD

ACFE®


Association of Certified Fraud Examiners

GLOBAL HEADQUARTERS • THE GREGOR BUILDING
716 WEST AVE • AUSTIN, TX 78701-2727 • USA

# II. THE LIFE CYCLE OF A MORTGAGE LOAN

## Introduction

A key to detecting, preventing, and investigating mortgage fraud is to understand the weaknesses and stress points in the mortgage loan process. Those who commit mortgage fraud understand how to exploit those weaknesses. Consequently, to become better at enacting controls, detecting red flags, and investigating fraud, examiners must look at the mortgage loan process as a fraudster would.

Mortgage fraud is primarily committed by, or with the assistance of, industry insiders (such as builders, property sellers, loan officers, appraisers, realtors, attorneys, and title agents).

Moreover, mortgage fraud can be perpetrated at any stage of the mortgage process, but the majority is perpetrated at *origination*—the process whereby a borrower applies for a new loan and a lender processes the borrower's loan application. Fraud can be committed by anyone who has access to the loan application and supporting documents. Therefore, it is important to have an understanding of the key players in the loan process, including their roles and responsibilities, as well as the fraud schemes most likely to be associated with the key players during a mortgage loan transaction. The key players are:

| Process | Players |
|---|---|
| Origination | • Property seller<br>• Listing real estate agent<br>• Buyer/homeowner (borrower)<br>• Buyer's real estate agent<br>• Lender<br>• Loan officer<br>• Loan processor<br>• Appraiser<br>• Underwriter<br>• Mortgage insurance company |
| Closing | • Title agent |
| Sale to secondary market | • Secondary-market investor<br>• Mortgage recordation |
| Servicing | • Transfer to servicing company<br>• Payments on performing loans<br>• Loss mitigation on nonperforming loans |
| Resolution | • Prepayment<br>• Maturity<br>• Foreclosure into Real Estate Owned (REO) portfolio |

## Property Seller

In every purchase transaction, there is a property seller. The seller should be the entity or individual listed on the public deed records found in the county courthouse where the property is located. It becomes problematic when someone other than the owner of record enters into a transaction to sell a property they do not own.

In contrast, a refinance transaction should not involve a property seller because the borrower is the owner of record at the time of the refinance. There are exceptions to this rule, including refinance transactions involving divorce and inheritance.

### Types of Property Sellers

A property seller can be:

- An individual homeowner with equity
- A distressed homeowner
- A builder or developer
- A real estate investor
- A bank lender/secondary-market investor

### Individual Homeowner with Equity

In the majority of residential home transactions, the seller is an individual who wants to sell their property near its market value and who seeks to profit only from the sale of the home, whether it is their primary residence, an investment property, or a second home. An individual homeowner can facilitate, or become a victim of, mortgage fraud.

### *Distressed Homeowner*

As a result of the downturn economy, many homeowners suffered financial hardships that caused them to become delinquent, or have mortgages that far exceed the current value of their homes. These homeowners are commonly called *distressed homeowners*. Lenders have offered various programs to keep distressed homeowners in their homes (like loan modifications or principal forbearance) or sell their homes (like short sales or deed in lieu). Distressed homeowners who become desperate for relief can facilitate fraud or fall victim to it.

### *Builder or Developer*

A builder or developer might sell property. If, for example, someone is purchasing new construction, the seller is likely to be a corporate builder or developer. Sometimes, builders also purchase and renovate older apartment complexes into individual condominium units. A builder profits only when the property sells. Builders and developers have a stake in finding buyers who qualify for financing.

In general, builders cannot require buyers to use a specific lender or title agent as a condition of the sale. Allegations against builders for this practice include:

- Raising the prices of homes when buyers decline to use the builder's mortgage affiliate or subsidiaries
- Requiring buyers to deposit extra money in escrow accounts if they refuse to use an affiliated lender
- Coercing buyers into using a designated lender with the threat of withdrawing a seller's credit toward closing costs

When the real estate market started to implode from 2005–2007, some builders were stuck with excessive inventory, especially condos, that they could not sell. To incentivize buyers, builders and developers started offering monetary incentives that far exceeded program guidelines, and failed to disclose these to the funding lender.

### *Real Estate Investor*

Investors who purchase properties, renovate them, and resell them are known as *property flippers*. It is not uncommon for such a property seller to hold the title for a short period of time, usually just long enough to renovate and find a buyer. The flipper might take title to the property under a corporate name or an LLC; therefore, when the property is sold, the property seller might be a corporation rather than an individual.

### *Bank Lender*

When a bank takes back a property due to foreclosure, the property becomes an asset of the bank. Therefore, a bank (or investor) can become the property seller when foreclosed property is sold. This type of property is often referred to as *real estate owned* (REO) property.

## Expectations of a Property Seller

The seller of property is generally expected to:

- Sell their property in good faith and at market value. In a distressed situation, the value might be at the lower end of what the market will bear.
- Be the owner of record of the property when entering into a purchase contract to sell it.
- Expose the property to the open market so that competition dictates its market value (in an arm's-length transaction).

- Disclose the relationship between the seller and buyer (in a non-arm's-length transaction).
- List in the purchase agreement all the contributions the seller is willing to make toward the buyer's purchase of the property.
- Require a good-faith earnest money deposit (EMD) from the buyer to be placed in escrow with a title agent.
- Disclose addenda with all incentives on the purchase contract.
- Convey to the buyer in the signed warranty deed all interest in the real estate.
- Record the warranty deed in public records.

**Fraud Trends Involving Property Sellers**

Often, the property seller is the orchestrator of mortgage fraud and typically the primary beneficiary of the illicit proceeds. To commit fraud involving origination or servicing, the seller might:

- Have a mortgage broker's license.
- Steer the buyer to a certain loan officer by making promises of instant qualification or reduced origination points.
- Recruit borrowers via advertising or real estate investment clubs.
- Enter into a purchase contract with the borrower on a property not currently owned by the seller (misrepresenting himself as seller).
- Instruct the buyer to provide all documentation to them, and have no contact with the loan officer.
- Coach the borrower through the loan application process.
- Access the loan officer's credit bureau subscription and run a credit report.
- Order and pay for the appraisal, and supply comparable sales for the appraiser to use.
- Offer lavish, undisclosed incentives to borrowers.
- Make an undisclosed offer to pay the borrower's down payment.
- Float a loan by making the first year's mortgage payments.
- Misrepresent the condition or construction of the property they are selling.
- Facilitate or perpetrate fraud by strategically defaulting to a workout program.
- Misrepresent their financial condition in order to qualify for a workout program.
- Fall prey to schemes intended to assist the borrower, but often put the borrower in worse shape than before.

## Real Estate Listing Agent

Real estate listing agents are usually independent sales workers who provide their services to sellers and buyers through a licensed real estate broker on a contract basis. The listing agent is paid a commission on the sale price received for the home.

### Licensing and Regulation of Real Estate Listing Agents

Every state requires real estate brokers and sales agents to be licensed. For more information about each state's licensing and regulation, visit the National Association of Realtors State and Local Leadership Directory at www.realtor.org/leadrshp.nsf/?OpenDatabase.

### Property Listings

This section examines two listing services:

- The multiple listing services (MLS)
- The limited service listings

#### *Multiple Listing Service*

The multiple listing service (MLS) is a database that allows real estate agents representing sellers to share property information with other brokers who might represent potential buyers. The MLS combines the listings of all available properties within a given MLS service area and can be accessed by any broker who is a member of the National Association of Realtors (NAR).

The purpose of the MLS is to enable efficient distribution of information so that when a real estate agent is contacted by someone interested in purchasing a property, that agent might search the MLS and retrieve information about all homes that meet the buyer's criteria (e.g., location, price range, and size).

The MLS is governed by private entities, such as county or regional boards of realtors, and the rules governing it are set by those entities with no state or federal oversight beyond any individual state rules regarding real estate. The entities that oversee the MLS set their own rules for membership, access, and sharing of information.

Listing agents create the listings for properties being sold by their clients, the property sellers. Only the listing agent can modify, update, and change the information in the MLS. A person selling their own property in a for-sale-by-owner (FSBO) transaction cannot put a listing for the home directly into the MLS. Similarly, an agent who chooses not to join NAR cannot access the MLS, and an agent who does not operate within NAR's rules cannot join or access the MLS.

In many transactions where sellers are looking for buyers, the property is listed in the MLS. Typically, a property listed in the MLS is considered exposed to the open market. Real estate transactions that occur between two people and that have not been exposed to the market are considered private sales. Because of their limited exposure, private sales might not be good indicators of market value.

### *Limited Service Listings*

The real estate industry offers flat-fee MLS or limited service listings. These listings include a licensed subscribing agent who places pertinent information about a property into the MLS for a flat fee. FSBO properties are sometimes listed this way.

## Expectations of a Real Estate Listing Agent

A real estate broker is an agent of a seller and, therefore, a fiduciary to the seller. People in fiduciary relationships have legal liabilities, and as a fiduciary, a real estate broker legally owes specific duties to their principal (the seller). Under the fiduciary relationship between the listing agent and seller, the agent is generally expected to offer the following services:

- Run a market analysis to help determine the fair market value of the property.
- Advertise the property.
- Negotiate the best possible price and terms for the sale.
- Review all written offers with the seller.

In exchange for representing the seller, the agent receives a commission when the house is sold. A typical commission for listing a property is 3–6% of the final sale price.

## Fraud Trends Involving Real Estate Listing Agents

The listing agent might:

- Breach their fiduciary duty to their client by failing to act in the client's best interest to profit monetarily.
- Help conceal the incentives that the seller offered to borrowers by:
  - Holding seminars to help recruit buyers
  - Managing the incentive program offered by the property seller
- Act as the loan officer.
- Provide fraudulent identifying information.
- Order appraisals and provide inflated comparable sales.
- Receive huge commissions, which are funneled back to the borrower.
- Hold an earnest money deposit (EMD) from the borrower instead of placing it in escrow with a title agent.
- Provide a fraudulent or misleading broker price opinion (BPO) value under the market value for the bank REO, purchase the property from the bank, and then flip it to someone else.
- Inflate the market value of property through manipulation of the information from the multiple listing service (MLS) by:
  - Creating the listing after the property has been sold at an inflated value
  - Backdating the listing to make it appear that it was exposed to the open market
  - Altering the details in MLS after closing to disguise fraud

- Accept limited service listings with unreasonable or unlikely listing prices.
- Fail to present all offers to purchase to the seller.
- Facilitate a flip to a third party and pocket the difference between the two sales.

## Borrower

The *borrower* is the individual or entity that requests funds from a financial institution to put toward the purchase price of a property. For the purpose of this course, the term *borrower* includes both a buyer in a purchase transaction and the property owner in a refinance transaction.

### Methods to Commit Mortgage Fraud

The borrower might use armchair investors, straw borrowers, or accomplices, or use information obtained via identity theft to commit mortgage fraud.

#### *The Armchair Investor*

An *armchair investor* is typically an ethical, legitimate, though naïve and trusting, individual who has been seduced into thinking that investing in real estate is quick, easy, and profitable. They might have read a book on how to get rich quickly by investing in real estate, or they might know people who have profited from recently acquired properties.

The armchair investor hopes to cash in on the lucrative real estate market by getting something for nothing. Often, they believe industry insiders who claim that borrowers can qualify for multiple property purchases with no money down. In many cases, the properties sold to armchair investors are in inner-city areas and need extensive repairs. Someone selling to an armchair investor might claim that any necessary repairs have been made and that the property is occupied by responsible tenants. In some cases, the armchair borrower does not even inspect the property before closing.

The armchair borrower might have no idea how they qualified for multiple loans and might not know the loan officer listed on their loan application. In many cases, the borrower is unaware that their qualifying documentation has been altered or fabricated. Even though all this information is included on the documentation they signed at closing, the closing might be rushed, and the borrower could be told to sign blank documents or assured that any corrections noted can be fixed after closing.

Schemes targeting armchair investors frequently involve *affinity fraud*—a type of fraud that focuses on particular target groups related by age, gender, religion, or some other social connection; it targets groups of people who have some social connection with the fraudster. That is, affinity fraud schemes target investors' sense of community that they share with the fraudster. For example, neighborhoods chiefly populated by racial minorities, especially immigrant groups, are targeted by those committing this type of scheme. Likewise, religious and professional ties are exploited in these schemes.

### *Straw Borrower*

A *straw borrower* is someone with good credit who takes out a mortgage loan for the benefit of someone else but has no vested interest in the property purchased with the loan and has no intention to take ownership of the collateral or repay the loan. Straw borrowers typically receive a fee for their efforts, and generally, they believe that they are obligated to reside on the property or repay the loan.

#### CREDIT-FOR-SALE STRAW BORROWERS

A credit-for-sale straw borrower is recruited for their good credit and receives a fee for purchasing property, but they have no intention to repay the loan. They might be told that their only contribution is to qualify for the loan; another party (often the perpetrator or a recruiter) will handle all other aspects of ownership, including renovating the property, finding a tenant, collecting rent, and making the mortgage payments and that ultimately the perpetrator will split the proceeds with the borrower. Common characteristics of credit-for-sale straw borrowers include:

- They are recruited for their high credit score.
- Their only contribution is that they have the ability to qualify for loans and they sign legally binding documents.
- They typically receive a fee for participation.

#### SPONSOR STRAWS

A *sponsor straw* is someone who agrees to cosign on a mortgage loan for an individual with poor credit, but at closing, the sponsor learns that they are the only person listed on the loan. Under duress, the sponsor is convinced to sign the closing documents as the sole borrower with the reassurance that, in a short time (e.g., one year), the title and loan transfers into the other person's name.

Alternatively, the sponsor, especially an out-of-state sponsor, is sent one set of closing papers that indicate they are a co-borrower signing a duplicate set. Once the sponsor signs the papers, one of two things might happen: first, the original borrower does not sign a duplicate set of closing papers, or second, the duplicate documents signed by the original borrower are discarded after closing. In either case, the qualifying documentation in the loan file has most likely been altered and false statements might have been made to facilitate loan approval.

Often, sponsor straws are related to the person with bad credit.

### *Accomplices*

In some mortgage fraud schemes, the borrower is an accomplice to the scheme, but generally, they are an unsuspecting individual. Because the borrower is typically the one most affected, they are most likely to squeal when the loan goes into default; therefore, perpetrators generally prefer to use the identities of unsuspecting borrowers.

### *Identity Theft*

Mortgage fraudsters might commit identity theft to further a scheme. *Identity theft* involves stealing a person's identifying information for an unlawful purpose. In the case of a mortgage loan, thieves steal someone else's identity to deceive a lender to loan money based on someone else's identifying information. For example, fraudsters might use someone else's government ID number to apply for a credit card or loan. Victims of this type of fraud are often unaware that someone has used their information illegally.

Often, industry insiders have private personal information (PPI) from previous transactions and use this information without the knowledge of the borrowers.

## Expectations of a Borrower

The borrower is generally expected to:

- Enter into a purchase agreement in good faith and with a full understanding of the magnitude of the transaction.
- Shop for a loan officer who offers the best loan product and understand the loan product being solicited.
- Accurately represent the reason for the loan to the loan officer.
- Accurately represent their employment, income, assets, and debts, and the intended occupancy of the property.
- Review, or hire an attorney to review, the closing statement prior to closing.
- Profit at the time of purchase only by becoming the owner of a property that is likely to increase in value through natural appreciation.

In a mortgage fraud scheme, it is possible that the borrower did not:

- Shop for the property purchased.
- Inspect the property prior to purchase.
- Shop around for a loan officer and the best rate or program.
- Pre-qualify for a loan.
- Comprehend what kind of loan they were given.
- Negotiate the best price.
- Hire a real estate agent.

- Speak directly with their loan officer.
- Receive their executed closing documentation after closing.

**Fraud Trends Involving Borrowers**

Since the mortgage crisis, good credit plays a major role in a borrower getting approved for a loan. With the credit crunch, there has been an increase in the number of "credit for sale" straw borrowers. These straw borrowers are usually recruited for their high FICO scores and offered a fee in exchange for their cooperation in helping a borrower qualify for a loan. Most straw borrowers enter into this agreement assuming that they are not responsible for the debt or maintenance of the property.

## Real Estate Buyer's Agent

In legitimate transactions, buyers might select real estate agents to help narrow down the choice of homes for sale. Buyer's agents have the same duties and fiduciary responsibilities to their clients (the buyers) as listing agents. They typically have access to the multiple listing service (MLS), but they are not allowed to alter or update listings they did not create.

**Fraud Trends Involving Real Estate Buyer's Agents**

The following are characteristics of mortgage fraud schemes involving the buyer's agents:

- There might not be a buyer's agent for the transaction.
- The buyer's agent might also be the mortgage broker.
- The agent might recruit the borrower by means of the MLS and, with access to the borrower's personal information, misrepresent the borrower's qualifications for a loan.
- The real estate agent might breach their fiduciary duty to their client by failing to act in the best interest of the buyer.
- The buyer's agent might not disclose contract addenda to the loan officer.

## Lender

The *lender* is the institution that provides the money for the loan. In most—though not all—mortgage fraud cases, the lender shoulders the loss. After the mortgage crisis during the late 2000s, some mortgage lenders stayed afloat by originating refinances.

Many lenders are non-depository institutions. Aside from those lenders that originate loans against their own portfolios of assets, lenders typically secure loan money from the following sources:

- Their own deposit base
- The secondary market (as discussed earlier)
- A warehouse line of credit

Many funding lenders, including non-depository mortgage lenders and commercial banks, maintain warehouse lines of credit to fund loans prior to sale to another lender or the secondary market. The lender handles all aspects of the origination, processing, and underwriting, and closes the loan using funds from the warehouse line of credit. The loan remains in the warehouse line just long enough for the lender to sell the loan to another lender or in the secondary market. Once sold, the warehouse line is repaid. A lending institution with a warehouse line of credit might commission a mortgage broker to perform some of the origination or processing functions.

The funding lender usually creates two key pieces of documentation:

- The mortgage or deed of trust—a document that lists the security interest and is typically filed as a public record
- The promissory note—a promise-to-pay document that spells out the repayment details of the loan

**Fraud Trends Involving Lenders**

A scheme used by lenders to raise capital is to the sell the same mortgage loan to more than one secondary-market investor; this scheme known as the *double-sold loan*. The original loan documentation is duplicated and sold more than once in the secondary market. To conceal the scheme, the lender remits the scheduled principal and interest payments to the servicer. Since all loans remain current, the borrower is not aware that their mortgage has been double-pledged unless one of the loans goes into foreclosure.

Red flags for this scheme include:

- Someone other than the borrower is making payments on the loan.
- The borrower receives late notices or tax invoices on more than one loan.
- The borrower notices more than one loan on their credit report.
- The lender fails to provide the note to the document custodian.

## Third-Party Originators (TPO)

**Mortgage Broker**

A mortgage broker originates loans for mortgage lenders and, in return, receives a commission. The loans close in the name of the funding lender. A mortgage broker has no underwriting delegation. Mortgage brokers prepare loan applications, order credit reports, order the appraisal, and gather all qualifying documentation that is sent to the lender's underwriter for approval.

### Correspondent Lender

A *correspondent lender* is an entity that typically closes mortgages it originates with a purchasing lender's funds. A correspondent might perform some or all of the following loan processing functions:

- Preparing the loan application
- Ordering credit reports
- Coordinating appraisals
- Ordering title reports
- Verifying the borrower's income and employment

The correspondent is typically delegated some, or all, of the underwriting approval. The mortgage is closed in the correspondent's name, but is funded by the purchasing lender. A correspondent might also commission a mortgage broker to perform some of the origination or processing functions.

### Fraud Trends Involving TPOs

Third-party originators can directly or indirectly perpetrate a fraud scheme by:

- Not having the necessary controls and procedures to prevent fraudulent originations
- Failing to perform background checks on loan officers or branch managers
- Having inadequate pre-funding quality control processes in place
- Failing to properly train, monitor, or supervise loan officers or branch operations
- Allowing branch operations to operate autonomously

## Loan Originators

The loan originator might or might not be affiliated with the lender that funds the loan. Loan originators are typically either:

- Retail loan officers
- Wholesale loan originators

### Retail Loan Officer

A *retail loan officer* works for the funding lender, whether it is a commercial bank or a non-depository lending institution that uses secondary-market funds, correspondent relationships, or warehouse lines of credit.

Loans originated by a retail loan officer are the most basic transactions with the fewest third parties involved. All parties can be employees of the financial institution, including the appraiser. All steps in approving the loan can be done in-house, and once the credit decision is made, the transaction is often closed in-house.

Being salaried, a retail loan officer might not make as much per loan as someone on commission, but the retail loan officer can take advantage of the referral network within the lending institution to originate more loans.

**Wholesale Loan Originator**

A *wholesale loan originator* is a mortgage broker or correspondent who partially originates and processes a loan for a funding lender. The funding lender then underwrites and approves the loan. The funding lender rarely has direct contact with the borrower during the origination process, but instead relies on the wholesale loan originator to order and obtain the appraisal. The funding lender depends solely on the integrity of the information provided by the mortgage broker when making an underwriting decision.

A wholesale loan originator is usually paid a commission and therefore might have more incentive to produce and close as many loans as possible. Because the wholesale loan originator is in control of all information related to the loan transaction, an unscrupulous originator is able to misrepresent any components they want.

**Expectations of a Loan Officer**

In general, the loan officer is expected to:

- Look out for the borrower's best interest.
- Interview the borrower and take a completed loan application, whether online, over the phone, or in person.
- Educate the borrower regarding the mortgage loan process and available products.
- Assist the borrower in deciding which program is best for them.
- Ensure that the borrower has a clear understanding of what qualifying documentation is needed.
- Gather the appropriate documentation from the borrower, not through an intermediary (such as the property seller).
- Maintain contact with the borrower throughout the approval process.

A loan originator usually produces three key pieces of documentation to include as part of the loan origination process: (1) handwritten loan application, (2) credit report, and (3) automated underwriting system (AUS) certificate. Typically, the loan application is completed by the borrower, but in many instances, a loan originator types the handwritten application based on online submissions or telephone conversations with the borrower. Once the borrower signs the loan application, the loan originator has the right to pull the borrower's credit report. In order to determine if the borrower qualifies for a loan, the loan originator enters qualifying information into an AUS and receives a feedback certificate to include in the loan file.

### Fraud Trends Involving Loan Officers

Loan officers might initiate fraud schemes by:

- Targeting lenders that have a reputation for lax controls and send all of their loans to such lenders
- Accepting a completed loan package from a property seller or other interested party, even though there has not been any contact with the borrower
- Accepting a borrower's qualifying documentation from someone other than the borrower
- Excessive underwriting submissions for one loan
- Consistently excessive yield spread premiums (YSPs)
- Originating numerous loans with similar patterns (e.g., loans using the same appraiser, loan officer, or loan type)
- Using a PO Box as the address on the loan application

## Loan Processor

The loan processor is responsible for taking care of every step in loan processing. Some loan officers gather all documentation directly from the borrower, but others turn this duty over to a loan processor. In smaller branches, the loan officer might also be the processor, whereas in larger companies, the processor might be at a central location removed from the loan officer's office.

The loan processor carries many responsibilities, including gathering and validating the information. To verify the borrower's monthly income, employment history, and closing funds, the loan processor can send verification requests to employers, mortgage holders, landlords, and lending institutions. The loan processor should verify that all the documents provided by the borrower are true and correct originals. The loan processor also typically orders the appraisal and places the order for the title commitment, which lenders use to confirm legal ownership and the legal right to convey title.

Typical verifications sent out by the loan processor include:

- *A verification of employment (VOE)* is sent to the borrower's current and past employers to verify employment information.
- *A verification of deposit (VOD)* is sent to the borrower's banks to verify the funds in the borrower's accounts.
- *A verification of mortgage/verification of rent (VOM/VOR)* is sent to the borrower's current mortgage company or landlord to verify current payments and their timeliness.

When the loan processor collects all the information, they verify that basic loan requirements have been met and packages the loan file in a manner that the lender specifies. The loan processor then sends the complete package—including the borrower's qualifying documentation, loan application, credit report, verifications, and title commitment—to the underwriter.

If the underwriting process (discussed later) exposes deficiencies in the documents provided by the processor, the underwriter issues certain conditions (known as *stipulations* or *stips*) that must be satisfied. The responsibility to satisfy such stips typically falls on the loan processor.

### Fraud Trends Involving Loan Processors

The loan processor might initiate a fraud scheme by:

- Working exclusively for one or more loan officers instead of for loan officers on a rotating basis
- Using fraudulent or forged documents to clear a loan's conditions to get the loan approved and closed
- Hurrying the loan's turnaround
- Accepting documentation from the property seller or another third party instead of the borrower
- Manipulating the automated underwriting system (AUS)

## Underwriter

The underwriter works for, or is an agent of, the lender. The underwriter issues the final approval on a loan. The underwriter is typically the person who obtains the appraisal report. Additionally, underwriters should be the lender's first line of defense in identifying red flags of mortgage fraud because they are typically the first person to see the loan package.

It is important to remember that the approval and documentation feedback supplied by the AUS is subject to the underwriter's review. It is also the responsibility of the underwriter to evaluate the aspects of the loan that are beyond the scope of automated underwriting. In short, the underwriter approves the loan, not the automated underwriting. However, some lenders put too much emphasis on the AUS and its findings and forgo the human element of underwriting.

### The Three Cs of Underwriting

When lenders are considering extending a loan, they assess the three areas of underwriting: credit, capacity, and collateral. These three areas are known as the three Cs of underwriting.

That is, underwriting is a blended analysis of these three factors:

- *Credit*: the likelihood that the borrower repays the mortgage
- *Capacity*: the borrower's ability to repay the mortgage
- *Collateral*: the borrower's personal property that the creditor has a right to seize if the borrower cannot pay the mortgage (Collateral ensures that if a borrower cannot or does not pay back their loan, the lender does not take a loss.)

Even if one of the three Cs is weak, a borrower is still likely to qualify for a mortgage, but the risk to the lender is greater. Because the lender faces greater risk in such cases, the interest rate on the loan or the amount of required documentation might be higher. Lenders layer the risk, so if the collateral risk is low, a lender might accept a higher capacity risk. If all three risks are low, the lender might lower the amount of documentation required. If all three Cs are weak (i.e., the risk to the lender is high), the borrower might not be able to obtain a mortgage. Each of the three Cs is discussed in further detail in a later chapter of this course.

**Automated Underwriting Systems**

One of the major changes in the mortgage industry in the past few years is the use of automated underwriting models to underwrite and approve mortgage applications.

Today, most loan originators use automated underwriting systems (AUSs). AUSs enable lenders to obtain a risk classification without traditional manual calculations and subjective analysis. Automated underwriting shrinks the timeline of the mortgage approval process from weeks to minutes, saving borrowers time and money and eliminating much of the frustration and uncertainty involved in getting a mortgage. The objectivity of the system also assures consumers that their applications are evaluated fairly.

The two largest mortgage investors—Fannie Mae and Freddie Mac—have their own AUSs for evaluating mortgage loans. Fannie Mae's system is called Desktop Underwriter, and Freddie Mac's is called Loan Prospector. These systems employ artificial intelligence with a predictive model that assigns a quantitative risk factor to individual mortgage applications. Many lenders underwrite their files according to these secondary market investors' guidelines to ensure the loans' eligibility for purchase by Fannie Mae and Freddie Mac.

The mortgage broker or lender enters loan application data into the AUS, and the system generates a findings report that indicates whether the loan application is approved. If the loan application is approved, the system generates the documentation required to verify the application data.

AUSs allow for multiple submissions, so it is possible to adjust unknown variable data fields—such as the purchase price, interest rate, or repayment schedule—to gain an approval. Although it is possible to adjust unknown variable data fields, it is not okay to manipulate non-variables such as income, assets, or occupancy to obtain approval. The integrity of the data is only as good as the person submitting it.

Because it is possible to adjust unknown variable data fields, the final submission might look different from earlier submissions. But some data should be relatively unchanged. For example, income does not typically increase dramatically during a short period. Bank balances could change, but such changes require explanation. One thing that might change is the primary borrower; they might decide that they need a relative to cosign if they have poor credit.

It is important to remember that the approval and documentation feedback supplied by the AUS is subject to the underwriter's review. It is also the underwriter's responsibility to evaluate the aspects of the loan that are beyond the scope of automated underwriting. In short, the underwriter approves the loan; loans are not approved through automated underwriting. But some lenders put too much emphasis on the AUS and forego the human element.

### Three Possible Underwriting Outcomes

After the underwriter reviews the entire loan package, there are three possible outcomes:

- *Approval*: If the application contains no issues and the underwriter has no questions, the loan is approved with no conditions.
- *Approval with conditions*: The most common outcome a loan approved with conditions. There are two types of conditional approvals:
  - *A prior-to-document conditional approval*: If the underwriter needs additional documentation before a final credit decision can be made, a prior-to-document conditional approval is rendered. In essence, the loan documents are not prepared until the condition has been met. An example of a prior-to-document condition is a pay stub required to validate the borrower's income.
  - *A prior-to-funding conditional approval*: If the loan can be approved, but a condition must be met prior to closing, a prior-to-funding conditional approval is rendered. In this case, the loan documents are prepared and sent to the closing agent, but the lender does not fund the loan until the condition has been met. An example of a prior-to-funding conditional approval is proof of sale of an existing home where the equity is used as a down payment.
- *Denial*: An underwriter can deny a loan if the application has substantial deficiencies and does not meet the minimum standards of the lender, or if the lender's secondary market investors require a second underwriter review of the loan package before a final denial is communicated to the borrower. When a loan application is denied, a letter with the reason for denial is sent to the borrower within three days of the final credit decision.

When final approval is granted, the lender draws up an approval letter along with closing instructions for the closing. An underwriter's compensation is usually not tied to the approval of a loan. The time required for the underwriting process is driven by the volume in the market.

### Expectations of an Underwriter

The underwriter is generally expected to:

- Review the loan package sent from the loan officer or processor to make sure it conforms to all the guidelines required for that product.

- Review the appraisal and title report.
- If necessary, perform further validation of property value, employment, loan payments, and credit.
- Ask for anything else necessary to assess the accuracy of the information.
- Have the ultimate authority over the approval of the loan.

**Fraud Trends Involving Underwriters**

Underwriters might initiate a fraud scheme by:

- Colluding with loan officers to clear conditions set forth by investor's guidelines
- Waiving documentation requirements
- Signing off on receipt of "phantom" documentation
- Altering documentation
- Turning a blind eye to multiple loan applications using the same verified funds
- Disregard additional debt service arising out of the other transactions

## Appraiser

An *appraiser* is a professional who provides *appraisals* (i.e., opinions of the quality, value, or utility of a specific property). Prior to passage of the Dodd-Frank Act, a mortgage broker or TPO could order the appraisal report, which was included as part of the package sent to the underwriter. However, Dodd-Frank requires independence of the appraisal process and therefore appraisal reports must be ordered by the funding lender. Appraisers can be employed by financial institutions, government agencies, real estate organizations, or they might be in business for themselves.

Appraisal management companies (AMCs) are becoming more popular with lenders. An AMC offers appraisal services to lenders by making use of professional appraisers acting as independent contractors; they use a fee-sharing arrangement that compensates both the AMCs for their marketing efforts and the appraisers for their expertise. An AMC manages appraisal vendors and all of the ordering, tracking, and delivery tasks that need to be attended to in a mortgage transaction.

There are four generally accepted classifications of appraisers:

- *Appraiser trainee*: someone who is qualified to appraise properties overseen by, inspected by, and signed by a supervising certified appraiser
- *Licensed residential real property appraiser*: someone who is qualified to appraise non-complex, one- to four-unit residences having a transaction value less than $1 million and complex, one- to four-unit residences having a transaction value less than $250,000
- *Certified residential real property appraiser*: someone who is qualified to appraise one- to four-unit residences without regard to value or complexity
- *Certified general real property appraiser*: someone who is qualified to appraise all types of real property

The appraiser is responsible for independently determining the value of a specific piece of property. Because collateral is such a major component of a loan decision, an accurate appraisal is critical to originating a quality loan.

**Uniform Standards of Professional Appraisal Practice**

Appraisers follow the Uniform Standards of Professional Appraisal Practice (USPAP) when conducting appraisals. USPAP represents the generally accepted and recognized standards of appraisal practice in the United States. The Appraisal Standards Board (ASB) of the Appraisal Foundation develops, publishes, interprets, and amends the USPAP. Through the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the federal government mandated that states enforce USPAP compliance by real property appraisers. As such, failure to comply with USPAP likely violates a law in a state where the property is appraised.

**Licensing Requirements**

To become a real property appraiser, a candidate must obtain the required education and experience and pass a state-administered licensing or certification exam. The minimum criteria for education and experience are set by the Appraisal Qualification Board (AQB), an independent board of the Appraisal Foundation. The minimum criteria are as follows:

| Classification | Hours of Education Required | Hours of Experience Required |
|---|---|---|
| Appraiser Trainee | 75 | Subject to direct supervision by a supervising appraiser who is certified in good standing |
| Licensed Residential Appraiser | 150 | 2,000 hours in no fewer than 12 months |
| Certified Residential Appraiser | 200 | 2,500 hours in no fewer than 24 months |
| Certified General Appraiser | 300 | 3,000 hours in no fewer than 30 months |

For more information relative to each state's requirements and licensing, visit the Appraisal Institute's website at www.appraisalinstitute.org/state-licensing-and-certification.

**Appraisal Report**

Appraisals can generate various reports, depending on the property type and lender documentation level. Some investors, however, allow property inspection waivers (PIWs) in lieu of appraisal reports. PIWs typically allow a mortgage broker or lender to sell mortgages to a secondary market investor without an appraisal and inspection report. Eligibility for PIWs is based on model-based collateral valuation typically performed on loans submitted through the AUS.