

# Incidences of Early Default And Mortgage Fraud Growing

By Frank McKenna

**M**ortgage loans that default within the first six months represent a significant and growing problem for lenders and investment banks. The problem of early payment default (EPD) is hitting the non-prime lending market particularly hard and having far-reaching effects. Many lenders are going out of business, others are raising their guidelines to accept only the best loans, and investment banks are kicking back record numbers of loans and refusing to buy certain loan pools altogether. While lending to risky borrowers is often cited for the current situation, there is another factor that is a major contributor to the problem – fraud. Analytic studies conducted at BasePoint Analytics, a leading fraud analytics and consulting firm, based on millions of historic loans have determined that up to 70 percent of the EPD problem can be attributed to some material misrepresentation provided during the application process by the borrower, broker or appraiser.

The majority of U.S. mortgage loans are sold to investment banks. These investment banks have the right to return purchased loans if they experience early payment default. Until recently, the industry experienced relatively few early defaults. When loans did go delinquent, investors were often willing to wait a few months to see if the loan would cure, which in many cases it did. If a borrower continued to struggle, they could often refinance and extract equity to keep up on their mortgage payments.

Home appreciation, however, has slowed, causing higher rates of default, particularly in non-prime lending. Investment banks are no longer willing to purchase pools of loans from loan programs that have demonstrated higher incidents of EPD. This in turn forces lenders to change underwriting policies, eliminate underperforming loan programs, sell portfolios and modify profitability

projections. Increasing defaults and shrinking origination volume results in higher loss rates and less revenue to offset losses, which will continue to roll through from loans originated in 2005 and 2006. This problem will likely worsen through 2007.

To better understand the dynamics behind this trend, BasePoint recently completed an extensive study to understand both the relationship between EPD and mortgage fraud, and the impact increasing EPD is having on the industry.

The study analyzed over three million loans originated between 1997 and 2006. This included over 16,000 loans that contained egregious misrepresentations in the loan file that later led to default. These misrepresentations included income inflated by up to 500 percent, appraisals that overvalued the property by 50 percent or more, fictitious employers and falsified tax returns.

## Defaulting Loans

The study confirmed that misrepresentations grossly affect the risk of a loan, finding that loans containing fraudulent misrepresentations were up to five times more likely to default in the first six months than loans that did not.

BasePoint found that the percentage of EPD loans that can be attributed to a fraudulent misrepresentation on the original application varies between 30 percent and 70 percent. The ratio varies based on a number of factors, including portfolio type, loan program, underwriting policies, and EDP definitions and measurement periods. The earlier the serious delinquency occurs, the more likely it is linked to a significant misrepresentation on the original loan application.

The study concluded that while a significant amount of EPD can be tied back to fraud, there are life events that play a significant part in the problem as well. In addition to fraud, some of

the most commonly discovered reasons for early payment default included natural disasters, such as Hurricane Katrina; hospitalization; loss of job; and divorce.

During the analysis, BasePoint analyzed loan attributes to identify patterns that may be linked more closely to EPD than to performing loans. The primary attributes related to EPD included:

- Loan program risk – (e.g. 80/20, stated income);
- Broker risk;
- Borrower's credit profile;
- Borrower's income and employment characteristics;
- Borrower is a first-time home buyer;
- Presence and size of seller concessions; and
- Geographic risk – property risk, zip code risk.

Stated income loans were found to be a higher risk. The study found that there are specific drivers that made certain stated income loans riskier than others. Additionally, the Mortgage Asset Research Institute Inc. reported in their Eighth Periodic Mortgage Fraud Case Report in April 2006 that one of their customers reviewed a sample of 100 stated income loans and found that when compared to IRS figures, "almost 60 percent of the stated amounts were exaggerated by more than 50 percent." Clearly, these types of income exaggerations significantly increase the risk of default.

The BasePoint study also determined that a small percentage of brokers contribute a disproportionate amount of loans that result in EPD. As found with one non-prime lender, less than 10 percent of brokers accounted for 100 percent of EPD, fraud and repurchase requests (see top graph below). This was not unique to this lender. Overall, the study revealed that EPD is concentrated within certain

*continued on page 35*

