
You Had Me at **'Hello'**

BY
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A simple verification call: Insurance companies use them to detect potential discrepancies on applications for auto insurance. Credit-card companies have used them for years to verify confirmed and unconfirmed claims of fraud. Online merchants have relied on them to verify they are not sending merchandise to a fraudster. They take an average of three minutes to complete. They are wildly successful in preventing fraud. They cost a few cents, and ultimately customers love them.

Sometimes a simple phone call can reveal a hidden fraud. Here's how mortgage lenders can leverage customer contact strategies to reduce their fraud risk.

Smile and dial—how three little words changed the credit-card industry

In 1992, credit-card fraud rates tripled over the course of three months. Card fraud became an epidemic in the financial services industry almost overnight as fraudsters learned how to counterfeit cards and then charge expensive merchandise such as computers, televisions, cash advances and even cars on those cards. In a period of less than two hours, a skilled fraudster could clone a card and easily use it to make charges of \$5,000 to \$10,000. Credit-card companies were losing millions overnight.

Card issuers scrambled to find a solution to the problem. They discovered the answer in an emerging technology called neural networks. Neural networks that were trained to mimic the human brain would analyze each card transaction in real time, compare the transaction with the real cardholder's prior spending activity and also compare it with known patterns of fraudulent spending. If the transaction looked abnormal and exhibited patterns of fraud, then it received a high fraud score so that it would alert the bank to the potential risk.

While neural networks proved to be extremely accurate in predicting that fraud was occurring, they didn't actually confirm the fraud—that was left to the card issuer to figure out. Issuers quickly determined the answer was as simple as picking up the phone and verifying the recent transaction activity directly with the customer.

The issuers hired teams of analysts to receive the alerts from the system and make immediate calls to the customers to verify that they were in possession of their credit card and that the activity was legitimate. The term "smile-and-dial" was born out of this entire process, because it all came down to the simple concept—just pick up the phone and call.

From 1992 to 1995, the concept of smile-and-dial was often challenged by old-school bankers. Many felt the best way to analyze data was by hiring fraud experts and relying on their human judgment. They didn't believe that relying on the ever-increasing power and capabilities of technology was the best way to find fraud.

One card issuer decided to test the concept of smile-and-dial. It created a test—comparing man versus machine. The issuer tested what happened when it relied on the neural network to tell it when to call the customer, versus letting human analysts review the data by hand and make the call when they determined it was appropriate. The results were conclusive:

- Human analysts were far slower than the neural networks;
- Human analysts were far less productive when they were not in smile-and-dial mode;
- Human analysts missed 50 percent of the fraud that the neural network detected; and
- When the bank relied on the human analysts, it lost twice as much money to fraud.

The evidence was clear, and the smile-and-dial approach has been considered a best practice in the credit-card industry ever since.

Mortgage fraud prevention often relies heavily on human judgment

Lenders will tell you that the problem with referring to a potential misrepresentation on an application as "fraud" is a bit like walking on a slippery slope. Because the actual intent to defraud the lender cannot be determined, and often the degree of misrepresentation is unknown, the whole notion of declining a loan for fraud reasons is at best a judgment call.

So where does harmless fudging of details end, and outright fraud begin? The mortgage industry has tried to qualify this by categorizing fraud into two categories. Fraud for housing (the good fraud) is when borrowers manipulate information harmlessly so that they can get into a property. They usually intend to pay, of course, but even the best-laid plans can go awry—such as when the Federal Reserve raised short-term interest rates 18 consecutive times, putting an end to the halcyon days of American homeownership.

Fraud for profit (the bad fraud) is when fraudsters, often working as a team, work to bilk lenders into lending tens of thousands of dollars more than a property is truly worth. This type of fraudulent loan, it is thought, might pay for a period of time until the scheme unravels and the lenders are left holding the bag.

So in short, just about all fraud matters in today's environment, whether the intent is to get into the house or use the

house itself as a means to con the lender out of lots of money. The degree to which the fraud matters is often a product of just how far the borrower stretched the truth. When mortgage borrowers fudge the number of years they have been employed somewhere, it matters a lot less than when they completely fabricate all of their employment documentation. The focus should be on misrepresentation that will result in financial loss to the lender.

Lenders are often forced to determine when a potential discrepancy is a misrepresentation

Mortgage lenders spend a lot of time and money trying to determine if a borrower, broker or appraiser has lied on a mortgage application. In general, most applications are scrutinized to ensure that misrepresentations haven't occurred in any of the critical underwriting areas—credit, capacity, collateral and character.

During their review of an application, lenders will analyze the loan file itself, query outside databases and ask some fundamental questions about the file, such as:

- Is the borrower really who he says he is?
- Is the borrower's reported income true?
- Is the borrower really employed where she says she is?
- Will the borrower really occupy the property?
- Is the property really worth what the appraiser indicates?

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■ Are the documents of reliance (e.g., verification of deposit, verification of employment, bank statements) valid?

Not surprisingly, lenders are able to find quite a few discrepancies during the underwriting review. Even though a discrepancy in information may be found (such as the borrower reporting an annual salary that is 25 percent higher than that of others for a similar occupation), the process of concluding that the discrepancy is an actual misrepresentation is not where the process ends. The underwriter must then make a judgment call on whether the discrepancy is considered extreme. If it is extreme, the underwriter may condition the loan for further documentation from the originator, or in some cases decline the loan outright.

While this process may take anywhere from 30 minutes to three hours, in many cases the verification is not completed. If originators actually fulfill the conditions, then the whole process can start over again with another review.

With such a cumbersome and potentially disjointed process, it is understandable how cases of fraud can slip through. The process of classifying a mortgage fraud is at best an educated opinion, but is rarely ever a proven fact.

Smile-and-dial—an emerging best practice for mortgage fraud prevention

It is clear that the fundamental fraud-risk-management issues for the mortgage industry are 1) the time-consuming nature of manually analyzing loan files for fraud risk and 2) the reliance on human judgment to classify a loan file as fraudulent. These just happen to be the same risk-management issues that the credit-card industry grappled with in 1992, when fraud losses nearly crippled that business.

There are a growing number of former credit-card fraud managers who are migrating to roles in mortgage fraud management and are convinced that the tried-and-true practices from the card industry will work in reducing mortgage fraud. They are implementing neural network technologies that predict which loans are most likely to contain misrepresentations by the borrower, and then placing phone calls to independently validate key pieces of information on the application with that borrower.

Deciding which borrowers to call

Contacting borrowers during the loan origination process can be an expensive and time-consuming process. Because the overwhelming majority (99 percent or more) of borrowers are honest and have no misrepresentations in their loan files, contacting all borrowers to stop the few bad apples doesn't make a lot of sense.

Understandably, lenders do not want to make calls to all their borrowers; rather, they select only those who appear most at risk for fraud. Typically, lenders will choose the riskiest 3 percent to 5 percent of loans for which a borrower verification call is in order. A model that rank-orders loans according to their level of fraud risk is often the most efficient tool for this selection of riskiest loans.

Deciding what questions to ask the borrower

After the riskiest loans are selected, the decision about what to ask the customer must be made. Lenders can adopt a dynamic, rotating list of questions based on the most likely type of fraud that is occurring, or a static list of questions that all potential borrowers would be required to answer. In general, borrowers are satisfied with participating in a phone call that lasts five minutes or less, so lenders keep the verification calls to a short list of the most pertinent questions.

A remarkably efficient list of questions that exposes fraud instantly can be developed. Take, for example, the following list of questions that can be asked of a borrower. This simple list of questions took a lender approximately three minutes to complete with a borrower, and it resulted in detecting significant misrepresentations in more than 50 percent of the calls that the lender placed in 2007 on a set of stated-income loans originated through its wholesale channel. In most of the cases where misrepresentation was discovered, the borrower reported significantly less annual income than was indicated on the loan application. In one case, the borrower's actual income was half of the application amount. The borrower believed the broker had adjusted his income to help him qualify for the loan. The list of questions went like this:

■ We received an application for a mortgage loan for you. Can you verify the address of the property that this loan is for?

■ Will you be moving into this property from your current address?

■ Can you confirm the name of your employer?

- How long have you been employed there?
- Can you provide me with your annual income?

Deciding where to call the borrower

Borrowers can typically be reached at their home, business or cell phone number. Verification calls that are placed to the borrower's place of employment have proven exceptionally valuable. Because employment- and income-based fraud are so prevalent, lenders find that when they try to contact a borrower at his or her place of employment, the phone number is either disconnected or, in some cases, the business has no idea who the borrower is.

Deciding if there are fraud signs during the calls

There are generally two ways that misrepresentations are exposed during verification calls: Borrowers tell you information that doesn't match the application, or they hesitate or can't remember information.

Borrowers are often unknowing victims of the fraud themselves. They will answer the questions truthfully and provide the lender with accurate information. If the originator has changed information on the application without the borrower's knowledge, these misrepresentations are often exposed immediately. This is particularly common in the area of income manipulation, where originators falsify the borrower's income to fit the lender's debt-to-income (DTI) ratio requirements.

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In the case where a borrower hesitated or cannot remember key pieces of information on the application, these can be indications of fraud as well. Because fabricated information is false, it is often difficult for the borrower to truly remember what information he or she fabricated at the time of the application. In the case of occupancy, if a borrower cannot remember the address of the property, it is often the case that it is an investment property and not the home that he or she plans to live in.

The benefits of smile-and-dial

The power of verification calls in preventing mortgage fraud is in the earliest stages of being discovered. Yet it has already proven useful by a top-five lender and top-10 subprime lender. While it is true that verification calls are quick, cheap and work well, the many side benefits are still emerging.

■ Verification calls offer definitive proof of fraud: Lenders are finding that they can decline or condition a loan in minutes versus a long investigation process.

■ Verification calls protect borrowers: Verification calls offer lenders another layer of ensuring that borrowers are not victims of identity theft or predatory lending from a dishonest originator.

■ Verification calls can be expanded to include

affordability education: Lenders are under increasing pressure to ensure that they are informing borrowers of the affordability of the loan program. Verification calls provide them direct contact with borrowers prior to funding the loan.

■ Verification calls reduce defaults: One large lender found through analysis in late 2007 that verification calls placed with the borrowers prior to closing reduced the level of early payment defaults by 20 percent. There are several theories on why the correlation exists, which include the fact that the call deepens the borrower and lender relationship.

The concept of using verification calls to reduce fraud and other types of risk is growing. Lenders have a greater appetite for reducing risk, so they are looking at simple techniques that work. In addition, lenders realize that contacting customers

by phone can build trust with the borrower and result in better-performing loans over the long term. **MB**

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