REGULATORY FRAUD REPORTING LOST IN A SEA OF CHANGE?

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SUMMARY

In 2012, the Bank Secrecy Act expanded its requirements for reporting of mortgage loan fraud to include nonbank residential mortgage loan originating companies. This expansion was expected, over time, to help the ability of regulators and the mortgage industry to have greater transparency in and awareness of mortgage fraud trends. However, more than three years after the effective date of the regulation, reporting levels are a fraction of estimates. Has this regulatory change been lost in the shadow of other changes, such as TRID?

This article provides insight into the history of Suspicious Activity Reporting and Anti-Money Laundering requirements and identifies potential discrepancies and complexities in deciding how to approach reporting as potential fraudulent trends continue to evolve.

BACKGROUND AND TIMELINE

The Currency and Foreign Transactions Reporting Act of 1970 (which legislative framework is commonly referred to as the Bank Secrecy Act or BSA) requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. It was passed by the Congress of the United States in 1970. The BSA is sometimes referred to as an anti-money laundering law (AML) or jointly as BSA/AML. Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. (See 31 USC 5311-5330 and 31 CFR Chapter X [formerly 31 CFR Part 103]).

Beginning in 2002, mortgage loan fraud has been called out as a specific area of interest for the Bank Secrecy Act Suspicious Activity Reporting.

From 2002 to 2012, Suspicious Activity Reports (SARs) for mortgage loan fraud were filed primarily by depository institutions, and reporting volumes increased significantly from 2002 to 2011. Because much of the reported activity was found during review of defaulted loans years after the actual suspicious activity, the reporting peak (Figure 1: red line) shows a five- to six-year delay versus the start of suspi- ➢

cious activity peak (Figure 1: blue line). Regardless of "delayed discoveries," the increase in the volume of actual reports was definitely signaling a very large rise in mortgage loan fraud in the years before the financial crisis.

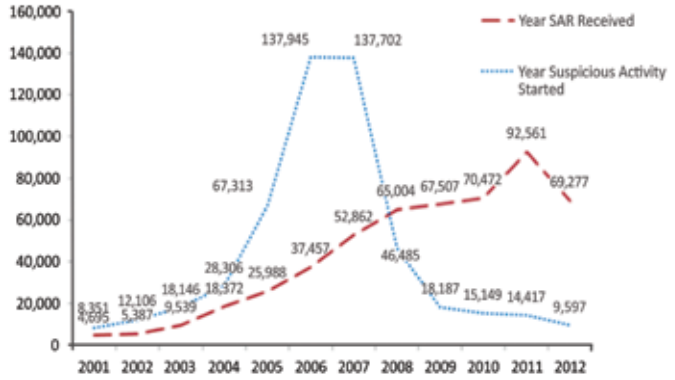

Figure 1: FinCEN 2012 SAR Data

Beginning in 2012, nonbank lenders were included in the responsibility to maintain anti-money laundering programs and file Suspicious Activity Reports. Prior to this, they did not file SARs.

KEY DATES:

February 14, 2012 – Final Rule published requiring nonbanks to comply with AML and SAR requirements.

"The SAR regulation requires reporting of suspicious activity, including but not limited to fraudulent attempts to obtain a mortgage or launder money by use of the proceeds of other crimes to purchase residential real estate." (Federal Register Vol 77 Feb 14, 2012)

August 13, 2012 – Effective date for compliance with the Final Rule.

April, 2013 – Electronic filing standard became effective; therefore, Suspicious Activity Reports were required to be filed electronically.

August, 2014 – A separate designation of financial institutions for "Loan or Finance Company" was effective within the FinCEN electronic reporting system.

Today, the Financial Crimes Enforcement Network (FinCEN) makes summary data publicly available for SAR filings filed through the electronic system. In 2012 and 2013, SAR summary data compilation and availability had multiple changes and inconsistencies. Therefore, the 2014 and 2015 filing levels from the FinCEN SAR Stats site were used for this article.

MARKET SHARE INCREASE FOR NONBANK LENDERS

Originations in the industry moved away from nonbanks after the financial crisis, but nonbanks are now making a strong comeback. In the fourth quarter of 2015, nonbank lenders accounted for 48.7 percent of GSE-securitized single-family mortgages, up from 12 percent in 2010 and 31percent in 2013. Given the trend, it is likely that 2016 originations will be evenly split between banks and nonbanks. From a SAR perspective, half of the suspicious mortgage origination activity is likely occurring in nonbanks—the newly included institutions in the 2012 SAR reporting expansion.

RELATIVELY LOW FILINGS

It is evident that nonbank SAR reporting is understated given nonbank percentage of overall mortgage originations:

- Mortgage loan fraud SAR filings for depository institutions averaged 2,731 per month in 2014 and 2,134 per month in 2015.
- To estimate filing for nonbanks, institution categories of "other" and "Loan/Finance Companies" were combined. The combined estimates averaged 294 per month in 2014 and 390 per month in 2015.
- The estimate in the 2012 Final Rule for purposes of calculating the SAR reporting burden for nonbanks was 31,000 annually or 2,583 SAR reports per month.

Comparing nonbank filing levels to depository institution filing levels and to the estimates in 2012, suggests that the nonbank SAR filing rates are much lower than expected. The impact of delayed discoveries may account for a portion of the difference, but lack of awareness of requirements and immature programs in nonbanks are likely larger factors.

COMPLEXITIES IN REPORTING – SHOULD YOU OR SHOULD YOU NOT?

Nonbanks range in size from very small sole proprietorships to large corporations. Although most nonbanks may have employees with prior experience in depository institutions, most are unlikely to have ➢

experience in SAR reporting.

Even depository institutions with mature SAR policies and years of feedback from BSA examinations may struggle when determining whether a situation of mortgage fraud or suspected mortgage fraud should be reported. Misrepresentation and fraud can occur over the life of the loan, from origination through servicing, loss mitigation, and REO dispositions, and the schemes and trends can change over time. The mortgage industry does not have a single authoritative definition of what constitutes actual or attempted misrepresentation or fraud.

Most origination-type misrepresentations are based on false statements or omissions regarding the borrower's ability to qualify for the loan or misrepresentation of the terms of the transaction or settlement details. Often, the intent behind misrepresentation appears clear, such as the case of a fabricated or altered paystub or bank statement. But sometimes it is uncertain whether discrepancies are due to misunderstanding, incomplete documentation, or a true intent to defraud.

An example of a less clear situation is where a borrower refinances a home they currently occupy for cash out prior to purchasing another home. On the standard loan application, the occupancy question is phrased: "Do you intend to occupy the property as your primary residence?" The application question does not specify for how long the applicant intends to occupy. However, at closing, the mortgage document includes a covenant that the borrower intends to occupy the property within 60 days and for a period of 12 months.

If the borrower uses the cash out from the first property to purchase a new primary residence and moves to the new property, is this a case of intentional fraud, incomplete documentation, or a misunderstanding?

Was there a single mortgage loan officer on both transactions? What was the timing between the transactions? Did the borrower have a prior application on the refinance that was counter-offered as an investment property and withdrawn?

If these other factors influence the SAR filing decision, it is likely that situations which appear similar initially may result in different decisions. Therefore, it is prudent to have policies, guidance, and/or documentation to support each decision.

The financial regulators 2014 Bank Secrecy Act/Anti-Money Laundering Examination Manual acknowledges: "The decision to file a SAR is an inherently subjective judgment." It then emphasizes the institution's process to escalate and evaluate situations rather than individual decisions.

BEST PRACTICES

Given the ambiguity involved in making the decision to report or not, the following guidelines are suggested:

- Work with your legal or compliance experts for guidance on AML and SAR compliance.
- Create and execute on a policy regarding employee training for identification and escalation of suspicious situations to promote consistency in filing.
- Include auditable fraud prevention and detection processes in your transaction and quality control workflows.
- Determine if a formal decision process for filing is prudent for your organization. If you have a process, adhere to it consistently.

CONCLUSION

Mortgage loan fraud Suspicious Activity Reports in the years before the financial crisis indicated a sharp trend of increased problematic activities. The expansion of Suspicious Activity Reporting and anti-money laundering requirements to nonbanks was a positive step in closing gaps that could be exploited by criminals, and makes lending employees in all lending institutions accountable for controlling and reporting fraud. Successful execution of the expansion will provide FinCEN, regulators, law enforcement, and most importantly, the mortgage industry with a more complete and possibly timelier view of fraud activity. As we enter an era of increased credit availability, the more robust SAR requirements and resulting filing levels may be an even better warning if these changes are accompanied by unacceptable fraud risk.

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