

LENDERS COMPLIANCE GROUP

“Converting Risk to Opportunity”

ADVISORY OUTLINE

May 2, 2008

Lenders Compliance Group specializes in providing regulatory compliance and mortgage loan quality assurance services to federally regulated banks and their mortgage company subsidiaries, Mortgage REITs, Mortgage Bankers, Mortgage Brokers, Warehouse Banks, Correspondent Lenders, Wholesale Lenders, Servicers, and HUD/VA Mortgagees, Loan Correspondents, and Agents. We provide a complete outsourcing of risk management, such as implementing complete regulatory compliance programs which include risk assessment and administration, or by supplementing internal resources. Our professionals have an average of 20 years in the financial services industry, consisting of former compliance officers and managers, former regulators, legal counsel, and underwriters who have created and implemented successful compliance programs.

Our unique **CORE COMPLIANCE MATRIX™** (CCM) and **CORE COMPLIANCE RATING™** (CCR) provide a review and quantitative evaluation of the regulatory risks associated with a financial institution’s Compliance Program. A **CORE** review of the Compliance Program, Organizational Structure, Regulatory Risk, and Enforcement Strategies of a lending institution afford an analysis of and corrective actions to its regulatory, legal, and operational conditions.

FinCEN Issues Report Warns of Money Laundering Methods and Trends in Residential Real Estate Industry

On May 1, 2008, the Financial Crimes Enforcement Network (FinCEN) issued the latest in a series of reports, which are based upon analysis of suspicious activity reports (SARs) provided by the financial industry. The report, entitled *Suspected Money Laundering in the Residential Real Estate Industry: An Assessment Based Upon Suspicious Activity Report Filing Analysis (April 2008)*,¹ identifies several transactional typologies and associated illicit activities that may be perpetrated by individuals or groups seeking to launder funds via residential property transactions.

The study confirmed an increase in the number of SARs indicating suspected money laundering in the industry which tracks closely with the past expansion of the real estate market, especially in calendar years 2004-2005.² Although calendar years 2005-2006 saw a pronounced flattening in the percentage increase of filings, this could be explained by the general slowdown in residential real estate market activity resulting in part from an increase in mortgage interest rates during that time frame.

A total of \$1.1 trillion worth of adjustable rate mortgages (ARMs) reset in 2007. With ARMs trending higher than fixed rates, a major shift into fixed rate mortgages may result. Though the refinancing of these loans would probably not pose as high a level risk for loan fraud and money launderings as would new loans, the report states that “such a wave

of refinancing could correlate with an increase in SAR filings reporting money laundering associated with the residential real estate sector.”³

Although SAR narratives reporting suspicious activity associated with the residential real estate industry are relatively common, only about 20% of such filings reportedly describe suspected structuring and/or money laundering, and of those, only about 11% described any other illicit activity including tax evasion, fraud, or identity theft. In 5.5% of the SARs sampled, builders, contractors, and rehabbers were the most commonly reported professions associated with the residential real estate industry and suspected of being involved in residential real estate-related structuring and/or laundering were. Tax evasion seems to have been the impetus to structure and/or engage in money laundering.

Significantly, as the report describes, more than 75% of reported suspects had no professional relationship with the residential real estate industry and any reported collusion with various real estate or construction professionals was somewhat rare. Money launderers were found to use many techniques, including: structuring large transactions into smaller amounts in order to evade detection; using “straw buyers” to front for the true purchaser; and, fraudulent documentation. In some cases, laundering money through residential real estate was found to support tax evasion, fraud, and identity theft.

Typologies

Several fraud and identity theft typologies include:

- Check kiting on real estate accounts
- Real estate investment accounts used to promote a potential pyramid scheme
- Fraudulently acquired state and federal tax refunds laundered through mortgage trust accounts
- Mortgage loans granted on the basis of fraudulent appraisals
- Identity theft utilized to drain the balances of home equity lines of credit accounts (HELOCs) and to layer illicit proceeds from money laundering activities.

Tax evasion typologies include:

- Cashing checks payable to businesses and the diversion of cash business receipts in a manner possibly designed to evade taxes
- Misusing the tax exempt status of organizations to conduct real estate-related businesses and disguise the profits as contributions.

Persons, Professions, and Businesses Involved in Structuring, Money Laundering, and Associated Crimes Tied to Residential Real Estate

There were 1,095 SAR filings in the reviewed sample, of which 747 were found to be relevant to the study. As indicated above, about 20% of these concerned suspected structuring and/or money laundering. Of the 161 subjects reported in 151 filings, a total of 122, or 75.78%, were unaffiliated, that is, individuals not employed by a residential real estate-related entity. As a group, builders, contractors, and rehabbers were the next most frequently reported subjects in nine (5.59%) of the reported occurrences.

The following chart provides the matrix of the persons, professions, and businesses referenced in the 151 sampled SAR narratives.⁴

Subject	Reported Occurrences (#)	Total Reported Occurrences (%)
Unaffiliated Individual	122	75.78
Builder/contractor/Rehabber	9	5.59
Escrow Company	5	3.11
Real Estate Company	5	3.11
Title Company	5	3.11
Mortgage Company	4	2.48
Bank Officer	3	1.86
Attorney	2	1.24
Loan Broker	2	1.24
Development Company	1	< 1.00
Landlord	1	< 1.00
Settlement Service Company	1	< 1.00
Time Share Company	1	< 1.00
TOTAL	161	100.00

Straw Buyers Transactions – Outline of a Typical Scheme

- 1) The money launderer finds employed individuals willing to accept a fee to allow their identities to be used to apply for residential real estate loans. (Sometimes the money launderer can falsify the applicant's income and employment status by controlling this information through legitimate or front companies.)
- 2) The Straw Buyers bank account is then usually temporarily funded by the money launderer prior to the application process.
- 3) The mortgage company processes the application and determines that the applicant is employed and has sufficient funds to qualify for the loan.
- 4) Once the loan is approved and funded, the money launderer often moves the money out of the Straw Buyer's account and into another Straw Buyer's account, and the process repeats itself.
- 5) Loan payments are made by the money launderer on a timely basis using illicit funds. (Payments may be made in the form of money orders or other negotiable instruments, bearing the name of the Straw Buyer, or actually debited from the Straw Buyer's bank account, which is controlled by the money launderer.)

Money Laundering through a Real Estate Entity – Outline of a Typical Scheme

- 1) The money launderer converts illicit cash into negotiable instruments, including those purchased by others.
- 2) These funds are then deposited to personal and/or non real estate-related business accounts.
- 3) Then these funds are “layered” further through accounts of complicit residential real estate-related services.
- 4) Finally, the funds are eventually returned disguised as the sales proceeds of real property or in payment for non real estate-related business goods or services purportedly provided to the residential real estate-related company by the money launderer.

Action Plan

- Thoroughly review the institution’s Compliance Program to be sure it contains appropriate policies and procedures for monitoring mortgage fraud and provides an Ethical Standards Statement with respect to residential loan originations.
- Review Best Practices guidelines, such as those offered by Freddie Mac.⁵
- Implement a Mortgage Fraud Screening Checklist for such indicia as the mortgage loan application; credit report; verifications of employment and deposit; pay stubs; Forms W-2 and 1099; Tax Returns (Form 1040); Schedules A, B, C, and E; bank checks; sales contract; Escrow/Closing instructions; appraisals; Preliminary Title Report and Title Search; and the HUD-1 Settlement Statement.
- Enforce a Red Flags Protocol on all mortgage loans.
- Conduct a random sampling Mortgage Quality Control audit based on various criteria, such as loan characteristics, real estate-related services, and product type.

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¹ *Suspected Money Laundering in the Residential Real Estate Industry: An Assessment Based Upon Suspicious Activity Report Filing Analysis (April 2008)*. For Internet access, go to: http://www.fincen.gov/MLR_Real_Estate_Industry_SAR_web.pdf or contact us and we will send you a package containing the subject report and relevant previous reports.

² Preceding FinCEN studies confirmed similar trends, detailed particularly in the following two FinCEN reports: *Mortgage Loan Fraud* and *Money Laundering in the Commercial Real Estate Industry*.

³ *Supra* note 1, p. 14. See also: *Statement of Sheila C. Bair, Chairman, FDIC, on Recent Events in the Credit and Mortgage Markets and Possible Implications for US Consumers and the Global Economy*, before the *Financial Services Committee US House of Representatives, 09/05/2007*. Freddie Mac predicted steady levels for fixed-rate mortgage interest rates continuing through at least the first quarter of 2007. See *Anatomy of a Housing Recovery, December 2006 Economic Outlook*, from Freddie Mac’s Office of the Chief Economist.

⁴ *Supra* note 1, p. 15.

⁵ *Fraud Prevention – Best Practices*, from Freddie Mac