Laundering the Proceeds of Mortgage Loan Fraud

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Abstract

The opportunity for mortgage fraud in Asia is significant as lending in many markets lacks proper credit controls, insider fraud checks and do not exploit technology fully. Rising property prices create an opportunity for a fraudster to use fraudulent overvaluation as a part of the fraud scheme. Information sharing between banks and in some cases between branches of the same bank, can also be poor leading to heightened risks. Identity theft is a very significant issue and can be perpetuated in Asia with a degree of ease in many markets. Laundering the proceeds of fraud is an essential step once a fraud has generated a benefit. Even without any monetary loss, identity fraud can be used to facilitate placement of the proceeds of crime into mortgage accounts as down payments and installments. Payments from/ sales to offshore companies can be used to layer the monies. Key to the success of money laundering schemes is the usage of offshore shell companies and trusts by the money launderer. Offshore links in transactions can be a red flag to investigate further. Supervisors, enforcement and especially industry bodies need to proactively get involved in some of the new initiatives discussed in this paper focusing on better credit standards, insider fraud, technology adoption and an early alert system.

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1. Introduction

Mortgage loan fraud and money laundering are intimately linked as the proceeds of fraud need to be laundered to give the monies the perception of legitimacy. Many jurisdictions now require filing of Suspicious Transaction Reports under AML laws wherever fraud gives rise to a benefit. In Asia, China and Japan are the main mortgage markets.

In the US, mortgage fraud has increased five-fold in the last decade and is now center stage. Around $2.5 trillion in mortgage loans are estimated to be made in 2005\textsuperscript{1}. Industry studies suggest that between 10 and 15 percent of all home loan applications involve some fraud or misrepresentation. As many as 50 percent of all early defaults have some form of misrepresentation, as do 25 percent of all foreclosures. Losses on fraudulent loans equate to approximately 37% of the loan balance\textsuperscript{2}.

The FBI estimates that 80% of all reported fraud losses involves collaboration or collusion by industry insiders: mortgage loan officers, mortgage brokers, appraisers, real estate agents, title agents and lawyers. Organised crime group perpetuate equity skimming, property flipping, and mortgage-related identity theft which are the main drivers of mortgage fraud numbers in the US\textsuperscript{3}.

Property is a preferred laundering technique (with or without mortgages) because of the traditional lack of/ quality of regulation/reporting requirements of many of the parties involved in a typical property transaction/ the property registration office, including non-bank mortgage lenders and company formation agents.

Mortgage fraud is a large and complex area - this article will explore some aspects including the link with money laundering. It will focus on China because it is the largest mortgage market in Asia and IMF estimates of money laundering is as much as US$24 billion annually.

\textsuperscript{1} US Mortgage Bankers Association forecast
\textsuperscript{2} US FFIEC White Paper on Third Party fraud, February, 2005
\textsuperscript{3} FBI Financial Crimes Report, May 4, 2005
2. Risks

Of the three stages of international money laundering – placement, layering and integration – property is a favorite in the final integration stage of laundering. Even without any monetary loss, identity fraud can be used to facilitate placement of the proceeds of crime into mortgage accounts as down payments and installments paid in cash and monetary instruments purchased at banks. Payments from/ sales to offshore companies can be used to layer the monies. Notably, the proceeds of white collar fraud are now also being used to finance terrorism/ terrorists need safe houses.

Mortgage fraud can be extremely difficult to detect as technology has made the falsification of documents (property, tax returns, bank statements, utility bills, identities) easy. Stolen identities are used to deceive lenders into believing that the mortgage loans are of good credit quality. Forty percent of the economic crime the Scotland Yard deals with has something to do with, or is tainted by, identity theft. Rapidly rising property values and low lending rates is a recipe for a scam as price rises cover the fraudulently inflated prices/appraisals. Both compartmentalization of loan processes and compensations that are commission-based have also significantly contributed to mortgage fraud. Finally, it is also difficult to prove collusion or overvaluation (especially where it falls in a 10% band), making prosecution difficult.

Employees engaging in frauds often fit a profile with extraordinary financial needs/ hardships. However, many of the most scandalous and larger insider loan frauds have been committed by employees from a perfect social background with a clean track record, creating a false sense of security that aided them.

Fraudsters pose as potential buyers to obtain details of properties to apply for mortgages. Appraisers or solicitors help them compile false documents/ declarations to overvalue properties. ‘Straw buyers’ (individuals who are paid for the use of their name and ID number) are used to set up nominee loans. These can be third parties, their relatives or trusted associates.
3. Some Interesting Schemes

1. A drug trafficker in China uses the proceeds of drug trafficking to purchase a property partly in cash and the remainder through a mortgage in the name of a ‘straw buyer’. A broker helps to create a false earnings and savings history for the borrower. Loan installments are repaid in cash and monetary instruments obtained by changing the cash at different banks. On full payment, the property is then sold to a shell company controlled by the criminal, for a nominal sum. The shell company then sells the property to an innocent third party for the original purchase price. Hence the proceeds of crime get shifted to the shell corporation and the dirty money origins are disguised. Monies held offshore are now borrowed through another front company and invested in new properties, factories, cars, stocks etc. The borrowing company is part of a trust arrangement in which the beneficiary is another trust (i.e., a layered arrangement). The trustees keep out of the day-to-day operations of the company.

2. In special mortgage schemes prevalent during the economic slump in Hong Kong, developers and banks attracted clients by offering them cash rebates and deferrals of 70 percent mortgage payments. A criminal syndicate uses drug addicts and jobless people to pose as buyers and sets up shell companies to falsify employment and salary records. The syndicate enjoys the incentives and rents out the flats until the deferred payments are due when the buyers declare bankruptcy.
3. A veteran Hong Kong lawyer helps a property developer steal HK$47 million in bogus mortgage loans from financial institutions over a four year period. The proceeds of the crime were transferred to the account of a former client of the property builder.

4. Equity skimming scheme: a criminal in China uses a ‘straw buyer’ to obtain a mortgage which is then rented out and the mortgage is never repayed. The rental payments are the fraudulent return before the ultimate foreclosure of the loan which can take time.

5. A criminal gang across China, Hong Kong and Macau with semi-legitimate front restaurant businesses buy and sell properties amongst their companies (“property flipping”) through fraudulently/ incompetently prepared appraisals. Fictitious leases help to show a rental income to service the mortgage. They make their fraud profits through the receipt of mortgage loan proceeds on the second sale at the artificially inflated price. The appraiser is paid off.

6. A criminal in Hong Kong takes a mortgage with a false identification document to buy a property for a stated value that is lower than the market price – difference being paid in cash. The property is then sold at full market value and the dirty money transformed into a capital gain.

7. ‘Air loans’ - A criminal in Hong Kong falsifies property documents relating to a property in China not owned by him; he uses his front business. He also presents falsified bank, tax, business registration documents, fake IDs, and a fraudulent overvaluation. He works with corrupted middlemen to get a bank loan against a mortgage of the property which he then repays through dirty monies from an offshore company (owned/controlled by him) as proceeds of falsified trade transactions. The loan cheque is banked in another bank with the loan sanction documents as legitimate monies.

8. A criminal in China takes out a mortgage in the name of a Japanese firm that he purports to represent (identity theft) to buy a property that has an inflated price. The seller then kicks back the surplus as cash to the criminal who makes a net return of 20%. The criminal defaults on the loan and launders the proceeds of the fraud separately. The post-dated cheques for installments are all fake.
9. A criminal in China sets up a mortgage broker business. The business prepares and submits bogus mortgage loan applications to a foreign bank branch in another city and launders the proceeds of fraud by purchasing vehicles and paying kickbacks to loan “applicants”. (In variants of this scheme, the closing agent (depends on market practices) can play a key role in the diversion of disbursements.)

10. A drug trafficker in Hong Kong uses “straw buyers” to buy out land using money borrowed from the launderer’s offshore mortgage lending company where dirty monies are parked. The borrowers now default and the company takes deeds in lieu of foreclosure. It sells off the property and banks the proceeds with an onshore bank with the intention to launder it further.

11. A lawyer in Hong Kong turns criminal and applies for a mortgage against his non-resident client’s property by forging the documents/ manipulating the appraiser. He funds the down payment/ the first installment from the lawyer client-account and absconds with the proceeds of the loan withdrawn in cash. In other variants of such schemes, the lawyer helps drug traffickers using the lawyer client-account to make mortgage payments and pockets a cut for this service.

12. A criminal real estate investor in China, purchases run-down properties, secures fraudulent appraisals, and obtains mortgages in the names of straw buyers who are paid USD 2,000 for their role. The straw purchasers place the properties in foreclosure, leaving the real estate investor with the mortgage proceeds.

*The launderer is ultimately limited only by his imagination.*
4. The Insider Angle

There are many signs that could indicate potential fraud by an employee – for example, changes in employee characteristics, such as lavish lifestyles or avoiding taking holidays; changes in employee performance; or new business referred by a new employee in which the ownership structure of the entity is unduly complex.

Typical insider loan fraud situations include: nominee loans and similar transactions, conflicts-of-interests, bribes and kickbacks, loans tied to favors for friends and family, fictitious loans, foreclosed properties sold through preferential contracts, fraudulent loan arrangements to divert monies for another use\textsuperscript{4}.

\textit{Ongoing monitoring and awareness of an employee’s immediate situational factors is essential.}

\textsuperscript{4} US FFIEC White Paper on Insider Loan fraud, May, 2003
5. Offshore Shells and Trusts

Key in laundering schemes is the offshore connection. Corporate and financial secrecy ensures that a criminals name does not figure in the public records of an offshore shell company/trust making it difficult for law enforcement, creditors, and other to find out who owns or controls the entity. Bearer shares along with layered ownership structures including layered trusts, add to anonymity. Nominee services by company formation agents helps a criminal to move one step back from the public eye. In many offshore jurisdictions offshore companies can be set up through an email of a simple scanned document making identity fraud easy. Trust structures are thrown in to further increase distance with the criminal either having direct or indirect control on the assets held through a Private Investment Company (PIC – a shell company) administered under the trust deed. Trust administration companies are not regulated for money laundering in all offshore jurisdictions making the know-your-customer (KYC) standards poor in many jurisdictions. The settler could be a nominee of the criminal.

Numerous arrangements are possible including the criminal/ his nominee being the controller of the trust (control stretching from “consent” to “consultation”), co-trustee, director of the offshore company, authorized signatory of the offshore company, or the beneficiary of the trusts assets. The trust and the offshore company may be setup/ incorporated in different jurisdictions with bank accounts in a
third jurisdiction. The beneficiary of the trust can be another trust. The jurisdiction of the trust/status of the criminal as a co-trustee can be changed/revoked upon legal enquiries. All these features can be legally valid under the trust law in force in the jurisdiction and makes recoveries of the proceeds of a fraud scheme a nightmare. In the diagram above, the Isle of Man is a more reputed jurisdiction (albeit a favoured location for US tax evasion money); jurisdictions typically preferred by launderers for trust arrangements are in the Caribbean, South Pacific etc.

Add to the above, the issue of offshore bank accounts and banking secrecy. Bank accounts can be typically opened through simple notarization of documents and copies of utility bills. With the ease with which documentary fraud can be committed using technology, this is an easy hurdle. More so, notarization for false documents is easy to obtain in South Asia and many countries in South East Asia. Furthermore, evidence to support a criminal investigation is possible to obtain only through the formal channels set up by the two countries financial intelligence units. Typically, by the time a request for information is processed the fraudster/launderer can take his monies out.

The Financial Action Task Force (FATF) (the global standard setter on anti-money laundering and anti-terrorist financing) expects countries to enhance their controls on the beneficial ownership of offshore companies, trusts and linked offshore bank accounts. As of now many offshore jurisdictions give this more lip-service than effective KYC. Nominee services from company formation agents continue to allow the launderer to move out of the public eye. Furthermore, offshore companies do not require any filing of annual statements nor any auditing and the trust law could be creditor unfriendly.
6. Risk Management Framework

Management

- Senior management should be explicit about the company’s view on fraud through a documented policy that is communicated to employees.
- The organizational structure needs to be clear with a proper segregation of duties.
- Management oversight for example, reasonableness of business deals/arrangements should be independently validated; follow-up action on internal audit findings.

Training and Awareness

- Training and separately an awareness program is needed, designed to the needs of the target audience – loan officers, credit officers, internal audit etc. – based on their skills and experience.

Technology

- Some lenders also use electronic reviews of data, such as Automated Valuation Models (AVMs) that attempt to validate the appraisal’s determination of value and check for fraud red flags (although AVMs have not as of now fully replaced traditional appraisals and human judgment). A fraudster can sometimes lull a front office staff into a false sense of security, technology will remain impartial.
- A separate identity theft management program is needed by mortgage lenders. The anti-identity-theft programme should fully exploit technology/ non-documentary verification. Controls are numerous and involve physical verification, technology, databases. Checks include auto-verification of machine readable passports based on the ID details using a tool for this purpose.
Procedures

Third Party Fraud

- The procedures covering third party fraud should cover application, appraisal, credit report, closing or settlement (transfer of ownership from the seller to the buyer), mortgage broker, title insurance/opinion, verification of employment/deposits etc.

Monitoring Procedures

- Mortgage lenders should have adequate monitoring procedures for all intermediaries to a real estate transaction – brokers, appraisers, agents and lawyers – a critical pre-funding control. Appraisers should be independent of the borrowers and the brokers.
- Monitoring where the monies are coming from, ownership history of the property and who the property is sold to for links and suspicious transactions, is essential. Specifically, transactions on current accounts for loans against existing properties should be monitored thoroughly.
- Properly communicated and secure whistle blowing channels are essential.

Know Your Employee

- An expressed and applied code of conduct that must specify employee financial relationships that are not acceptable or other relationships that need to be controlled. It should be drafted taking account of insider loan fraud and should be impartially enforced and include sanctions.
- An essential defense against insider loan fraud is the use of proactive employment practices (see box). The extent to which employment practices are implemented may differ due to the size and complexity of the lending institution. Controls elsewhere may compensate for some of the controls, for example, review of the financial

Employment Practices

Comprehensive Background Checks
- Verification of educational transcripts
- Credit reports
- Reference validation
- Public records search (including petty criminal records)

Ongoing monitoring/ detection
- Changes in employees and directors' lifestyles, behaviors, and actions
- Periodic credit reports and public records searches
statements and tax returns of employees with outstanding loans, review of annual employee declarations of related interests, and ongoing review of the employee deposit and loan accounts\(^5\).

- Effective internal controls are needed that continually test whether the institution's monitoring systems will identify a dishonest insider committing loan fraud.

**Reviews/Audits**

- An independent loan review system.

- A strong internal audit that is timely, comprehensive and risk focused with specific tests for insider complicity and collusion within the firm. It should report findings directly to the board of directors.

*Lax internal controls and internal audit, a culture that allows nepotism and exempts persons from controls – these are a sure formula for insider loan fraud.*

7. Best Practices

Regulatory/ Industry Role

Specialized best practice guidance on preventing mortgage loan fraud from third parties must be forthcoming from examiners and/or industry bodies.

Examiners and/or industry bodies need to give separate guidance on the know your employee program to prevent insider loan fraud.

Industry bodies representing mortgage lending firms should put in place a lender best practices program of voluntary certification to an annual independent audit to verify that day-to-day lending and business practices meet the requirements of the program. This is especially needed for non-bank mortgage lending firms.

Industry bodies should work with vendors to facilitate evaluation/ adoption of anti-mortgage fraud technology.

Early Alert System

D. James Croft founded the US Mortgage Asset Research Institute, Inc. (MARI) which operates a cooperative database containing reports on incidents of mortgage fraud. Croft says, "To successfully prevent mortgage fraud both employee/third party screening and a cooperative early alert service for material misrepresentation in mortgage loan applications (See www.mari-inc.com/mfas.html) are necessary. Markets like China, Hong Kong, Singapore should have an early alert service relevant to their markets. Where necessary, legislation should be passed to permit such services. Also, relevant industry bodies should be involved. MARI's cooperative database is endorsed by the US Mortgage Bankers Association, and that trade association support has been critical to our success. Sharing information across countries would need special information sharing arrangements between governments. Our experience is that mortgage fraud can be significantly controlled through such proactive and preventive measures."
Newsletter

A special e-news service that highlights case studies of mortgage fraud as they unfold is also necessary to increase awareness amongst mortgage lenders.

FIU Investigations

The STR filing requirements and investigation focus for mortgage fraud can be focused on separately by investigation authorities to enhance the turnaround time/quality.

Property Registration Office

With more persons being online, an automated notification system to alert homeowners by email of any changes to the ownership rights of their property will also help.
8. Asia Realities

The above risk management framework/global best practices need to be adopted in Asia. Asian banks have weak know your intermediary and know your employee practices. Corruption is a major issue in many countries like China, Philippines, Indonesia, Thailand, India, Pakistan, with select exceptions like Singapore, Hong Kong.

Asian banks have started adopting know your customer name matching technology for monitoring against databases of sanctions/high-risk persons and entities. However, the development of effective credit risk databases and an early alert system for mortgage fraud is in its early stages, the former making progress in markets like Hong Kong and Singapore for individuals (www.creditbureau.com.sg) and companies.

China is concerned about money laundering through the property sector/mortgage lending fraud. Laundering in China often represents proceeds of tax evasion/corruption, recycled through offshore companies (Hong Kong is a favorite) and returned to China as foreign investment. It could also show up as repayments of mortgage loans/sales of mortgaged properties to offshore companies.

Reports show a rapid mortgage growth in China between 2002 to date. As of now only 1.5% of residential mortgages are non-performing and the down payments in areas where prices are rising rapidly has been increased to 30% of the property value.

However, recent scams in China have highlighted that there are hidden problems of a flawed credit approval process and lax risk controls underscoring the need for skilled and experienced personnel (lending officers, internal audit, credit departments etc.). The Agricultural Bank of China made a lending

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6 Transparency International’s annual Corruption Perception Index
7 South China Morning Post, May 1, 2006
loss of US$1.1bn in 2006 with the collusion of employees\textsuperscript{8}. Earlier there were numerous cases of embezzlement by employees of the Bank of China.

Furthermore, lending practices in China are not the best: for example, lenders accept statements from employers which can easily be fraudulently prepared, it is difficult to find out details of other mortgages on different properties, property valuations are not as precise as in Hong Kong, and sharing of information amongst bank branches can be a problem. This is changing slowly. Recent initiatives include requirements to deposit property ownership certificates and the planning of a national consumer bureau (currently only Shanghai has a good database). However, reports suggest that data is not updated in a timely manner. Earlier, mortgage applications were made via property builders who used fake mortgages to perpetuate fraud\textsuperscript{9}.

\textsuperscript{8} Complinet, June 30, 2006

\textsuperscript{9} South China Morning Post, May 1, 2006
Development of solid credit and fraud/money laundering risk management practices in Asia is a prerequisite to controlling mortgage fraud and associated money laundering. Supervisors, enforcement and especially industry bodies need to proactively get involved in some of the new initiatives discussed here focusing on better credit standards, insider fraud, technology adoption and an early alert system.

The run on a Macau bank in September 2005 as a result of the US designation as a primary money laundering concern highlights the need for good anti-fraud and anti-money laundering systems.