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Residential mortgage fraud Boom and bust





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Contents

Introduction	1
Mortgage on purchase	3
Refinance mortgages	6
House builder incentives	10
Subsale fraud, back-to-back fraud and "flipping fraud"	14
Valuation fraud and professional negligence	17
Buy-to-let new build fraud rings	20
Mortgage application fraud	22
Checking the mortgage application	24
Investment scheme scams	27
Conclusion	30



Residential mortgage fraud

Boom and bust

Introduction

This document is intended as a brief guide to residential mortgage fraud in England and Wales in the context of the great house price boom and bust of the early 21st century. There are occasional references to the United States of America. This is not a complete or definitive guide. Mortgage fraud techniques evolve continuously. Steps now being taken to combat residential mortgage fraud are largely beyond the scope of this guide. Nothing in this document amounts to legal or other advice. Before taking or omitting to take any step in connection with mortgage fraud or related matters you should seek independent legal advice.

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WHAT IS MORTGAGE FRAUD?

Mortgage fraud is obtaining mortgage funding for property transactions by the deliberate provision of false or misleading information to the lender and/or by the deliberate concealment of material information from the lender. It involves some kind of dishonesty, lies, misrepresentation or concealment intended to deceive or mislead lenders and pervert the loan underwriting process. Mortgage fraud ranges from so called “soft fraud” such as a minor income inflation in a self-certified mortgage application to serious and sophisticated criminal conspiracy.

Mortgage fraud is a close cousin to various other types of property fraud. Despite the credit crunch, mortgage fraud and real estate fraud are alive and well. Like pathogenic viruses frauds mutate into new forms in an attempt to evade countermeasures and exploit new found weakness – for example too much well-intentioned openness and transparency at the Land Registry.

Examples of property fraud include:

- Renting a property, pretending to be the owner, then selling it.
- Moving into someone’s house whilst they are working abroad and selling it.
- Foreclosure rescue fraud.

Mortgage fraud can be divided into:

- Fraud for property. The fraud is committed in order to obtain the property itself, perhaps to live in and perhaps to rent out.
- Fraud for profit. The property is just a vehicle to defraud lenders, investors and others of their money. Fraud for profit can balloon into large scale and very serious criminal activity.

THE TYPICAL RESIDENTIAL MORTGAGE PROCESS IN ENGLAND AND WALES

This section outlines the process by which residential mortgages are granted in England and Wales. This process provides the backcloth against which mortgage fraudsters operate. The process need not follow the exact sequence of events set out below. A lender or buyer may choose to instruct a licensed conveyancer or a solicitor.

MORTGAGE ON PURCHASE

Step 1:

Borrower finds a house to buy and agrees a price with the seller.

Step 2:

Borrower completes a mortgage application form (either hard copy form or on-line) which is submitted directly or via a broker or packager to a lender.

Step 3:

The lender investigates the value of the house or flat offered as security, the identity of the borrower and the strength of the borrower's personal covenant i.e. the borrower's ability to make the monthly mortgage payments and perform other mortgage covenants. We may pause here to note that mortgage fraudsters will attempt to deceive the lender about all or some of these items.

The property:

The lender takes a first legal charge over the property to provide security if the borrower defaults. The lender instructs a valuer to provide a written valuation the property.

The LTV:

The lender considers the loan to value ratio. If the property is valued at £200,000 and the applicants seeks to borrow £180,000 the LTV is 90%. The higher the LTV the higher the risk to the lender and, with the evaporation of home equity in the downturn, the borrower.

The Borrower's identity:

The lender and the lender's solicitor will carry out identity checks with a view to ensuring the borrower exists and is the person the borrower claims to be. Checks are also carried out to comply with anti-money laundering and proceeds of crime regulations.

The Borrower's covenant:

The starting point is the information provided by the applicant in the mortgage application form. The lender may use a manual system or an AU (automated underwriting) system or a combination. The lender may place great reliance on a credit score.

A credit score is predictive tool. It is a number believed to represent an applicant's credit risk, or, put another way, how likely the applicant is to be a good, non-defaulting borrower. This number is calculated using a mathematical algorithm and the data in the applicant's credit report.

A credit report is compiled by or prepared for a lender and contains detailed information on an applicant's credit history, including ID, credit cards, loans, previous credit defaults and recent credit enquiries by other credit providers.

Lenders use credit scores to establish product eligibility criteria and interest rates. Applicants with higher credit scores tend to get more attractive loan products with lower interest rates, reflecting supposedly lower credit risk. Credit report items such as previous county court judgements and mortgage arrears are likely seriously to lower the credit score.

Checks, intended to ensure that the loan conforms to the lender's own underwriting criteria, might include enquiries of credit reference agencies, former lenders, employers and accountants. The lender may even interview the borrower and in other cases be influenced by the information provided by the broker who may have interviewed the applicant. Some lenders place far greater reliance on the value of the security and pay much less regard to the strength of borrower's covenant. This is particularly so with self-certified loans where the lender places greater reliance on the borrower's own representations as to the amount of the borrower's income. This does not necessarily mean that lenders do not carry out any verification procedures.

Step 4:

When the lender is satisfied with the property valuation and the borrower's ability to make the monthly mortgage payments, the lender issues an offer of advance to the applicant and instructs solicitors. Some lenders instruct their own solicitors. Many lenders instruct the applicant's solicitors. Most mortgage lenders are or were members of the Council of Mortgage Lenders (CML). CML member lenders instruct solicitors acting for them to follow the instructions set out in Part 1 of the CML Lender's Handbook for Conveyancers. Individual lenders have special additional instructions and these are set out in Part 2 of the Handbook. You may download a copy of the Handbook from the CML website: www.cml.org.uk. The instructions spell out in great detail what the solicitor is required to do and what is and what is not acceptable. If the solicitor has any queries, he can call the lender's support office.

Step 5:

The solicitors deal with the usual conveyancing process with the seller's solicitors which includes:

- making local authority, town planning, building regulation and other searches and enquiries,
- raising enquiries of the seller's solicitors about the property,
- agreeing the form of the contract for the sale of the property and the form of the transfer to the buyer,
- raising requisitions on title (in these days of registered land, requisitions are mainly about the mechanics of completion and the discharge of the seller's mortgage(s)),
- dealing with exchange of contracts and completion,
- payment of the deposit on exchange,
- payment of the balance of the purchase price and other sums (such as apportioned outgoings) on completion.

Step 6:

When the solicitors' investigations, searches and enquiries are complete they normally submit a report on legal aspects of the property to the lender called a "Report on Title" or a "Certificate of Title". Under Rule 3.20 of the Solicitor's Code of Conduct a solicitor acting for both lender and borrower in a standard mortgage (lenders' mortgages are almost always "standard" for this purpose) of property to be used as the borrower's private residence must use the certificate of title set out in the annex to Rule 3. In practice, most certificates of title issued by solicitors to lenders in home mortgage transactions are in this form.

Step 7:

On receipt of a satisfactory Report or Certificate the lender arranges to send the mortgage advance to the solicitors' client account in time for completion – solicitors refer to this as "being put in funds" by the lender.

Step 8:

At completion the lender's solicitor ensures that the lender obtains a first legal charge over the property.

Step 9:

A solicitor who is acting for the lender and the borrower then submits a Stamp Duty Land Tax form to HM Customs & Revenue providing certain details of the transaction and pays any Stamp Duty Land Tax due from funds provided by the borrower. Upon return of the appropriate Stamp Duty Land Tax certificate from HM Customs & Revenue confirming that Stamp Duty Land Tax has been paid, the solicitor applies to the Land Registry to register the transfer to the borrower and the first mortgage to the lender. On completion of registration the solicitor checks that the transfer and mortgage are correctly registered then sends any relevant deeds and documents to the lender's deeds department for storage.

REFINANCE MORTGAGES

The process is very similar.

Steps 1 and 5 are omitted as the borrower already owns the property.

At completion the solicitor has an extra task - obtaining a redemption statement from the borrower's existing mortgage lender(s) and remitting sufficient funds from the new mortgage advance as may be necessary to redeem fully existing mortgage(s).

OUR FICTITIOUS CHARACTERS

Let me introduce you to our fictitious characters, used to illustrate mortgage fraud techniques. There is no suggestion that any real person or organisation with any of these names or similar names has engaged in fraud or improper conduct.

Rogue	the perpetrator of the fraud or the mastermind or criminal gang behind it.
Straw	the mortgage mule/straw buyer.
Crooked	the dishonest valuer who overvalues houses and flats to facilitate Rogue's mortgage frauds.
Bent	Rogue's dishonest conveyancer who either turns a blind eye to Rogue's fraudulent activities or knowingly facilitates them.
Shady Brokers	A firm of unethical mortgage brokers.
Sub-Prime	A new sub-prime lender eager to increase market share.
Dodgy Builders	A regional builder specialising in city centre flat developments. Their flats are well constructed. Dodgy builders are not members of the Home Builders Federation and don't subscribe to their Code of Conduct. When it comes to selling flats, Dodgy Builders do not abide by high ethical standards. Rogue, Crooked and Bent occasionally enjoy a quiet pint with Dodgy Builders' sales director.
Honest John	An honest member of the public duped into taking the role of a bit-player in mortgage fraud schemes.

IMPORTANT NOTE

There is no suggestion that house builders, valuers, mortgage intermediaries, solicitors and conveyancers involved in residential property are or have been in any way dishonest, unethical, depart from accepted professional or industry standards or break the law. It does appear however that relatively small numbers of them are implicated in mortgage fraud. Sometimes there may be only one fraudulent individual in an otherwise highly respectable organisation.

MORTGAGE MULES AND STRAW BUYERS

A mortgage mule is a loan applicant used by mortgage fraudsters to obtain a home loan. In the United States, a mortgage mule is called a straw buyer, or just a “straw”. In this guide I will use the term “straw buyer”.

Key features of a straw buyer:

- frequently used in fraud for profit schemes.
- may be a real person who is often offered payment for the use of their name and credit information.
- may be an undisclosed family member or foreign national.
- may be a synthetic persona created by the fraudster complete with photo-ID, tax and national insurance numbers and a credit history.
- may be a stolen identity.
- used as a front to cloak the true buyer and the true nature of the transaction.
- the straw buyer has no intention of making mortgage payments and probably does not have the means to do so.
- the straw buyer’s income and assets are fraudulently misrepresented.

Typical Red flags for the straw buyer mortgage applicant:

- First time buyer apparently committing to a substantial increase in housing expenses. Often this person is “living with parents or relatives” is aged in their 30s and claims to have a substantial deposit (without disclosing how the deposit was accumulated). It is often the case that the deposit is claimed to arrive by way of a gift from a relative.
- The straw buyer does not intend to occupy. The home may be an unrealistic commute from the alleged place of employment. The type or size of home may be implausible for the applicant’s profile.
- Income, savings and credit patterns may be inconsistent with the applicant’s overall profile.
- High LTV and/or significant seller’s incentives.
- Inconsistent signatures in the lender’s mortgage application file.

EXAMPLES OF STRAW BUYER MORTGAGE FRAUD

It's not difficult to work out how a straw buyer can help defraud a mortgage lender. I'll give one simple and one more complex example.

SIMPLE STRAW BUYER MORTGAGE FRAUD

Step 1:

It's 2002. Rogue owns a terraced house in a city in the north of England. Rogue wants to move south to a good new job and needs £145,000 for the property. The best offer he gets is £133,000. The market for that type of house in that location is slow. The true market value is about £135,000. Rogue's nephew, Straw, is a local college student living in rented accommodation. Cedric, Rogue's best friend owns a small but successful local business making widgets. Rogue has heard that David, a local mortgage broker is good at getting big mortgages for people with little income and few assets.

Step 2:

Rogue and Straw agree a "private sale" at £153,000 conveniently cutting the local estate agent out of a commission. David helps Straw complete his mortgage application form for a loan equal to a 95% of purchase price (£145,350). Cedric provides a false reference stating that Straw has worked as an account executive for Cedric for over 2 years and now earns £38,000 per year.

Step 3:

David submits Straw's mortgage application form to Sub-Prime, who make a 95% loan offer subject to property survey and valuation.

Step 4:

The local valuer instructed by Sub-Prime eventually values the property at £153,000. Why, if the property is only worth £135,000? This time, it's not valuer fraud. Firstly the valuer is misled by the false price agreed between Rogue and Straw, believing it to be agreed at arm's length in the open market. Secondly, David, the broker applies pressure both directly on the valuer and via Sub-Prime's underwriter to achieve the right value to make the deal stack up. The valuer does not want to get a reputation for being difficult or his work may dry up. Valuation is a matter of opinion. The valuer knows that for this property he has 10 to 15% "wiggle room" around the true value. Sub-Prime get most of their lending opportunities through mortgage brokers and other mortgage intermediaries. Sub-Prime's underwriter is anxious to please David the broker, because David sends them a stream of lucrative mortgage prospects, ripe for securitisation.

Step 5:

Rogue (seller) and Straw (buyer) instruct separate solicitors omitting to mention that they are related and it's a set up. Straw's solicitors also act for Sub-Prime on Straw's mortgage. The conveyancing process grinds on but there's a problem. Straw doesn't have a 5% or 10% deposit so he tells his solicitor that he's paid the deposit direct to Rogue.

Note: Straw's solicitor should report to Sub-Prime the fact that no deposit has been paid to the solicitor, but fails to do so. It's vital to Sub-Prime that Straw has some stake in the property. This time, it's not solicitor fraud but a negligent oversight by the solicitor's overworked conveyancing executive.

Step 6:

The sale to Straw completes and Rogue gets his £145,350 leaving him £70,000 equity after paying off sale expenses and his own mortgage. Straw, who has no income and no assets, never makes a monthly mortgage payment. Straw has no money invested in the property. He fades into the student community. Sub-Prime has a day one, non-performing loan, and a substantial loss.

A MORE COMPLEX STRAW BUYER MORTGAGE FRAUD

Straw was clearly one of the perpetrators of the fraud on Sub-Prime. Sometimes a straw buyer can be a victim and a perpetrator at one and the same time.

Step 1:

Rogue, a professional serial mortgage fraudster recruits Straw to purchase a buy-to-let property. Rogue claims that the property will be rented out to cover the mortgage payments and quickly resold at a profit. Rogue pays Straw £5,000 as an inducement.

Step 2:

Rogue has an arrangement with Crooked, a valuer prepared to over-value property for Rogue and some other mortgage fraudsters. Straw, at the instigation of Rogue, instructs Bent, a conveyancer prepared to facilitate mortgage fraud.

Step 3:

Rogue has a special deal with the seller of the house. The seller wants £500,000. Rogue arranges for the seller to sell to Straw at £600,000 but Rogue gets £100,000 cash back at completion. The seller is happy because he gets a sale at the price he wants.

Step 4:

Straw purchases the house with the help of a 90% loan (£540,000) from Sub-Prime. Crooked values the house at £600,000. The cash-back arrangement is not disclosed to Sub-Prime. After completion, Bent returns the £100,000 to Rogue, perhaps by a circuitous or disguised method.

Step 5:

No tenants materialise. No monthly mortgage payments are made. Sub-Prime are threatening to repossess the property. Straw realises he's been conned, his credit status is ruined and he faces possible bankruptcy for the inevitable mortgage shortfall. Rogue has effectively stolen £40,000 from Sub-Prime.

Step 6:

Rogue offers to "help" by selling the house. Rogue repeats the process with a new straw buyer and a different mortgage lender, but this time the price is £700,000.

Note:

Rogue might instead pay no 10% deposit (£60,000). Crooked will pay £500,000 of Sub-Prime's advance to the seller on completion and pay the remaining £40,000 to Rogue.

HOUSE BUILDERS' INCENTIVES

House builders provide many and various “incentives” to encourage buyers of newly built or refurbished properties. Incentives of themselves are both usual and lawful. Incentives may include payment of legal fees, payment of stamp duty, a holiday, a car on the drive, cash-back, a “mortgage subsidy” (essentially cash-back), the seller paying the buyer’s deposit (“seller gifted deposits”) and, in buy-to-lets a rental guarantee.

Incentives keep up the headline sale price whilst simultaneously allowing the buyer a discounted price. A mortgage lender needs to know the real price at which the property is changing hands (likely to be nearer the true open market price) and that the borrower has contributed the agreed percentage of the purchase price (i.e. has the right amount of “skin in the deal”). This is particularly so in high LTV mortgages. As described later, incentives impede transparency of purchase price, market values and comparables.

Incentives such as bulk buy discounts, cash backs, guaranteed rental income streams and subsidised mortgage payments can amount to very substantial discounts from the headline purchase price. Lenders are not unduly concerned about traditional incentives such as a fancy brick drive instead of gravel or extra tiling in the bathroom as they are *de minimis* when compared with the purchase price and improve the property anyway. When big, back-door price rebates are paid to buyers and not disclosed to lenders, lenders may regard the practice as redolent of fraud.

INCENTIVES IN PRACTICE

It's 2006. A house builder and a buyer agree a headline price of £275,000 for a new city centre flat. The valuer, encouraged by the house builder at the champagne sales launch, values the flat at this full purchase price. The buyer obtains a 95% mortgage i.e. £261,250. The lender is expecting the buyer to invest the other 5% (i.e. £13,750) of his own money in the flat. However, the house builder has agreed to provide an incentives package to the buyer. First a package of household extras and second payment of the buyer’s legal costs, including SDLT and Land Registry fees. This incentives package is worth some £11,000.

The real purchase price is £264,000. This is probably near the true market value. The buyer’s equity has fallen from £13,750 to £2,750. The LTV has increased from 95% to almost 99%, greatly increasing the lender’s risk.

On these facts, has mortgage fraud been committed?

The house builder:

There’s no real evidence that the house builder is part of a conspiracy to defraud the lender. However, the very practice of giving incentives might facilitate mortgage fraud by the buyer. Reputable house builders will tell you that they give incentives (which are entirely legal) to help sell houses at the best prices obtainable, not to facilitate mortgage fraud. In response lenders have said “OK, so disclose incentives to us”.

The broker:

It is common for the builder to use a mortgage broker as the conduit for the buyer to the lender. Applications where circumstances are not revealed, “slipped in” among a batch of straightforward deals from a broker tend to be less prominent, and may not be so carefully reviewed by lenders. Then the influence of the broker and the lender’s need for future business may be unhealthy.

The valuer:

There’s no evidence of fraud. The valuer may not even know about the incentives. Some valuers have an inbuilt tendency to try to reach a valuation that matches the purchase price agreed between the seller and the buyer. The lack of transparency has impeded the valuer’s opinion forming process. Maybe the valuer at first indicated £265,000 but the house builder’s MD phoned his boss and said “Who’s this comedian you’ve sent to value our development? If this is how you work, we’re not instructing you on our big new development across the road from your office.”

The buyer:

The buyer may or may not have committed mortgage fraud. Fraud would arise, for example, if the buyer lied to the lender about the incentives or deliberately failed to disclose them when asked to do so in the mortgage application form.

The buyer’s solicitor:

In this case the buyer’s solicitor is also acting for the lender, as is usual. The lender is a member of the CML (Council of Mortgage Lenders). The solicitor must comply with the lender’s Part 2 instructions in the CML’s Lender’s Handbook. In this case the household extras were not disclosable but the legal fees and expenses were disclosable. Unfortunately, no disclosure was made to the lender. Why not? We will probably never know. The file was dealt with by a locum covering for an overworked conveyancing executive who was on holiday. The locum has now returned home to New Zealand.

BULK DISCOUNTS

In normal market conditions, if a buyer agrees to take several units (say 5 flats), a house builder will usually allow a bulk discount, say 10%. This is legal and usual. Many professional buy-to-let landlords bought flats on a bulk basis. Fraud will arise if the buyer, perhaps with the active and knowing assistance of the house builder and possibly the valuer and conveyancer, sets out to deceive the lender. The buyer may say to the house builder “The units are £250,000 each. Sell me 4 units at the full price of £250,000. I’ll take 85% LTV mortgages on those units from four different lenders. I’ll take the whole of the discount on the 5th unit and pay you £150,000 cash.” Afterwards, the buyer will re-finance the 5th unit with Sub-Prime, taking an 85% LTV mortgage on a valuation of £250,000. Effectively, the buyer gets a £150,000 cash back (representing the discount) at this point.

Various schemes are possible. The central objective in each case is to deceive the lender as to the true purchase price. It’s perfectly legal to carry out the above transaction on a full and frank disclosure basis where the lenders, the valuer and the conveyancer know the whole story and the lenders consent to proceed. You might be thinking “Yes, but if the deal is honest, why not just buy 5 units at £225,000 each?”

THE LENDER'S RESPONSE TO HOUSE BUILDERS' INCENTIVES

CML DISCLOSURE OF INCENTIVES FORM

This is a key change intended to improve transparency. The form is required for all transactions on newly built, converted or renovated properties. Copies of the form and a supporting FAQ document may be obtained from the CML website: www.cml.org.uk.

The CML Disclosure of Incentives Form details all incentives and discounts offered by the developer. The developer will complete the form and provide a copy to the lender's conveyancer and to the valuer.

The Home Builders' Federation and Homes for Scotland support the CML changes and have already amended their individual codes of conduct, to encourage greater transparency amongst their membership. And a number of major builders have responded by taking individual steps to address this issue.

Mortgage application process

Lenders ask applicants to declare on their application form any incentive or discount they are being offered by the developer. Lenders are able to reserve the right to vary or withdraw an offer if it subsequently emerges that there was an incentive or other discount that was not declared.

Instructions to valuers

The Royal Institution of Chartered Surveyors (RICS) 'Red Book' of standard instructions to valuers has been amended by the RICS in conjunction with the CML to reflect concerns. The updated guidance emphasises the need for valuers to consider the effect of any sales incentives which could have had a distorting effect on the agreed sale price. Valuers may also need to look for comparable evidence beyond the immediate development. Same site comparables can be misleading.

Instructions to conveyancers

The Lenders' Handbook provides comprehensive instructions for conveyancers acting on behalf of lenders in residential conveyancing transactions. Section 6.3 of the Lenders' Handbook for England and Wales sets out what is expected of the conveyancer in respect of the purchase price. It provides that, unless specifically instructed by the lender (in its part 2 instructions), the purchase price for the property must be the same as set out in the instructions. If it is not, the conveyancer must tell the lender.

The conveyancer must also (if required to do so in part 2) tell the lender if the conveyancer becomes aware of any arrangement under which:

- there is a cash back to the buyer
- part of the price is being satisfied by a non-cash incentive to the buyer
- there is an indirect incentive (cash or non-cash) or rental guarantee

Such arrangements may lead to the mortgage offer being withdrawn or amended.

The conveyancer must also tell the lender if he will not have control over the payment of all the purchase money (for example, if it is proposed that the borrower pays money to the seller direct) other than a deposit held by an estate agent or reservation fee of not more than £1,000 paid to a builder or developer.

Law Society Guidance

The Law Society has produced guidance for its members on mortgage fraud, which states that a solicitor is under a duty to inform the lender of the true price being paid for a property. This includes not only informing the lender of straightforward price reductions, but may include other allowances which amount to a price reduction. The examples given in the guidance include incentives offered by builders such as free holidays and part-subsidisation of mortgage payments.

CML LENDER'S HANDBOOK PART 2 INSTRUCTIONS TO CONVEYANCERS ON INCENTIVES

Typically a conveyancer must now obtain a completed copy of the CML Disclosure of Incentives Form from the conveyancer acting on behalf of the seller of any property that is yet to be occupied for the first time, or for the first time in its current form, for example, because of a renovation or conversion.

The lender may not require disclosure of financial incentives which total less than, say, 5% of the purchase price.

The lender may not require disclosure of additional fixtures and fittings at the property.

The lender is likely to require disclosure of all other incentives.

SUBSALE FRAUD, BACK-TO-BACK FRAUD AND “FLIPPING FRAUD”

Sub-sales and back-to-back sales (which are a type of sub-sale) are legal and useful conveyancing procedures. The sub-sale is fairly simple, but very popular device for fraud. There's nothing illegal about buying property wisely and selling it immediately at a big profit. Fraud arises when participants deceive lenders and professionals as to what is really going on.

I'll use the term “flipping fraud” to describe this type of fraud. In technical conveyancing terms flipping fraud may or may not include a sub-sale or back to back sale.

“Flipping fraud” is the practice of purchasing and then quickly re-selling a home at an inflated price supported by a fraudulently inflated valuation, often to a straw buyer or duped buyer, usually with a high LTV loan far in excess of the true market value of the property.

First, a simple case of sub-sale fraud not involving the valuer or the conveyancer.

Honest John sells his house in Anytown to Rogue 1 for £250,000. This is the true market value.

Rogue 1 sells the house to Rogue 2 for £300,000. Rogue 2 applies to Sub-Prime for a mortgage loan of 95% of the supposed value of £300,000 i.e. £285,000.

Sub-Prime instructs eminent local valuers, Pigeon, Duck and Partridge to value the property.

Rogue 2 instructs eminent Anytown solicitors, Pheasant, Woodcock and Quail on the purchase and Sub-Prime also instructs them to deal with Sub-Prime's mortgage.

The two sales complete on the same day.

Sub-Prime does not know about the sale from Honest John to Rogue 1.

Rogue 1 and Rogue 2 are in league, conspiring to defraud Sub-Prime. They use £250,000 of Sub-Prime's advance to pay Honest John for the house and pocket the balance of the advance i.e. £35,000 less transaction costs.

Rogue 1 and Rogue 2 may disappear. Of course, Rogue 2 may be fictitious, essentially a fully synthetic borrower using a false identity or be someone vulnerable to pressure from Rogue 1.

Sub-sale fraud was very common in the 1980's and was unmasked on a grand scale in the 1990's house price crash. Various questions arose, for example:

1. Was the valuer negligent? Perhaps. Valuation is a matter of opinion and for this type of property the courts might allow a 10% margin of error. So a reasonable valuation could have been £275,000. In a rising market valuers can be misled by a false price which they believe has been freely agreed in the open market at arm's length. In my opinion, some valuers have an inbuilt tendency to try to value property at the price agreed by the seller and the buyer or as close thereto as is practicable.
2. Should Pheasant, Woodcock and Quail have spotted the fraud? Should the instant price rise of

£50,000 have alerted them? Should they have reported these facts to Sub-Prime? Questions such as this gave rise to complex litigation in the 1990's with lenders making claims against solicitors and those claims being defended vigorously by solicitors' professional indemnity insurers.

A VARIATION ON FLIPPING FRAUD

Rogue 2 waits for about a month, just long enough to become registered as owner of the property at the Land Registry, then sells to a third party. Rogue 2 is working in cahoots with a dishonest conveyancing executive in Bent's solicitors office. That executive fails to register Sub-Prime's first mortgage against the property, and does not redeem that mortgage upon completion of Rogue 2's sale to a third party. That third party might be an honest person, another Rogue (real or synthetic) or a straw buyer.

The Rogues make off with £35,000 plus the full sale proceeds of the house sale to the third party - less transaction expenses which will include a payment to Bent's dishonest executive.

INDUSTRIAL SCALE FLIPPING FRAUD

Where criminal masterminds or gangs team up with dishonest conveyancers, valuers and mortgage intermediaries, flipping fraud can be perpetrated on an industrial scale with potentially huge losses to lenders, even where the lender's first mortgage is properly registered at the Land Registry. The key elements are:

- A rogue masterminding the ring.
- A dishonest valuer issuing fraudulently inflated valuations (absolutely essential).
- A dishonest conveyancer (often but not always).
- A dishonest intermediary obtaining the mortgages (often but not always).

Where the ringleader or his nominees are purchasing the property he will extract a loan from an unsuspecting lender far in excess of the value of the property. He may, for example, persuade the seller to inflate the purchase price and kick-back the excess to him after completion. An unscrupulous residential property developer, anxious to off-load units might well be such a seller.

Where the ringleader or his nominees already own the property he might:

- Sell it to a straw buyer at an inflated price. The straw will borrow far in excess of the property value.
- Offload the property at an inflated price on a duped buyer. The duped buyer might be an innocent member of a fraudulent "investment club" set up by the ringleader. The duped buyer will borrow far in excess of the property value.

The sale price will be supported by a fraudulent valuation issued by the ringleader's "tame" valuer.

Fraudulent flipping is an engine of false house price growth. Besides cheating lenders and innocent buyers, homeowners in the wider community are misled as to the true extent of rising house prices. Those homeowners may be misled into paying an excessive price for a new home or into borrowing excessively against an unsustainable growth in home equity.

Please note that "flipping" is legal. Honest property investors have made substantial sums of money buying and selling property quickly. "Flipping" and "flipping fraud" are two entirely different things.

CHURNING

A property can be flipped several times, perhaps between multiple buyers and sellers within the ring, inflating in value each time. Phantom equity is extracted on each occasion. Inflated sales prices can be used as comparables for valuations for future flips. This practice is known as churning. Often the “transactions” are between different special purpose companies set up by (and often all owned by) the fraudsters. Those companies may be incorporated offshore and have helpful directors.

LOAN FLIPPING OR LOAN CHURNING

“Flipping” is also used as another term for “loan churning”. This occurs where an intermediary persuades a borrower unnecessarily to re-finance a loan in order to generate additional commissions.

COUNTER-MEASURES TO FLIPPING FRAUD

CML LENDERS HANDBOOK

The CML Lenders’ Handbook contains Rules for solicitors intended to prevent this type of fraud, for example:

- 5.1.1 Please report to us (see part 2) if the owner or registered proprietor has been registered for less than six months or the person selling to the borrower is not the owner or registered proprietor unless the seller is:
 - 5.1.1.1 A personal representative of the registered proprietor; or
 - 5.1.1.2 An institutional mortgagee exercising its power of sale; or
 - 5.1.1.3 A receiver, trustee-in-bankruptcy or liquidator; or
 - 5.1.1.4 Developer or builder selling a property acquired under a part-exchange scheme.
- 5.1.2 If any matter comes to your attention which you should reasonably expect us to consider important in deciding whether or not to lend to the borrower (such as whether the borrower has given misleading information to us or the information which you might reasonably expect to have been given to us is no longer true) and you are unable to disclose that information to us because of a conflict of interest, you must cease to act for us and return our instructions stating that you consider a conflict of interest has arisen.
- 6.3.3 You must report to us (see part 2) if you will not have control over the payment of all of the purchase money (for example, if it is proposed that the borrower pays money to the seller direct) other than a deposit held by an estate agent or a reservation fee of not more than £1000 paid to a builder or developer.
- A3.1.1 You must follow the guidance in the Law Society’s Green Card (mortgage fraud) and Pink Card (undertakings).

The Law has issued a practice note “Mortgage fraud practice note – 18 March 2008”. This contains valuable material on flipping and other frauds. I recommend that you obtain a copy from the Law Society’s website: www.lawsociety.org.uk

VALUATION FRAUD AND PROFESSIONAL NEGLIGENCE, BOOM AND BUST

A valuer can over-value homes in a number of ways. Those ways might be innocent, negligent or fraudulent. Lenders and in particular buy-to-let lenders have a real concern about many valuations of new build properties (especially flats) prepared during the house price boom. Inflated valuations are at the heart of many mortgage frauds including flipping schemes and excessive incentives, particularly back-door cash rebates.

Ideally, a valuation should:

- State the true and accurate open market value of the property.
- Provide information about the location, features, state and condition of the property which might affect its value.

Accurate valuations:

- make it less likely that a buyer will pay too much for the property and fall into negative equity in a house price crash.
- enable lenders properly to manage risk and to lend within the loan-to-value criteria of their product.

A valuer might be persuaded to issue inflated valuations in the following circumstances:

- Giving in to pressure from almost anyone involved to “make the figures work”.
- Failing to disclose damage to the property, dilapidations and the cost of re-instatement.
- “Photo-fraud”. Taking photos from an unusual distance (to obscure name plates of unauthorised business occupiers) or from an odd direction (to hide the next-door sewage facility).
- Assisting a seller, such as a house builder, to artificially ramp up the valuations of new-build.
- Misleading a lender as to the true market value of the property by looking only at the headline sale price and deliberately ignoring significant back-door price rebates.
- Over-valuing new build to help a buy-to-let fraud ring extract large cash-backs.
- With buy-to-let, valuers might overstate potential rental incomes as well as capital values to enable the buyer to meet the lender’s underwriting criteria. (With rental property, the rental income greatly influences the underlying capital value).
- Working with a buyer to inflate artificially the value of the property to enable a re-finance or a further advance to take place.
- With new build, ignoring the fact that the property has not been constructed in accordance with building regulations and so cannot lawfully be occupied.
- With new build ignoring the absence of NHBC insurance policy or equivalent.

Some valuers may have “streamlined” the valuation process. Examples include:

- A desktop valuation with no actual inspection of the property.
- Reliance on what similar neighbouring houses sold for recently with no actual inspection of the property.
- Drive-by valuation.

- Valuation off-plan with no re-inspections.
- Re-cycling of same valuation for multiple addressees when a property is flipped.
- Same-site comparables.

In my view, many valuers, acting in good faith, may strive to value a property at the price apparently agreed between the seller and the buyer at arm's length. After all, a property is worth what someone is prepared to pay for it in the open market. The innocent valuer will not realise that the price is a set-up between connected fraudsters. The innocent valuer will not know that the headline purchase price he or she is striving to value the property at is artificially supported by a big, back-door cash-back, mortgage subsidy or rental guarantee. The innocent valuer will not know that the comparable values he has taken from Dodgy Builder's neighbouring development have been pumped up by previous fraudulent valuations or hidden cash-backs. In multiple unit schemes (particularly larger blocks of flats) an unscrupulous developer might sell the first few units to connected parties at inflated prices in order to establish overstated comparable values. An innocent valuer who during the boom used only "same site comparables" is particularly vulnerable to this deception. Revised RICS "Red Book" valuation rules now require offsite comparables.

Valuers can be placed under pressure to give the "right" valuation to enable the deal to go ahead. The pressure is not usually to commit outright fraud by producing a huge overvaluation but to be as optimistic as possible. Pressure or manipulation might emanate from the seller, the buyer, the broker, the house builder, the estate agent or even the lender's underwriter. In one case, on receiving a valuation that was "too low" the underwriter asked the valuer to go back to see if he could increase his valuation. The valuer obliged. The broker sent a good stream of business to the lender and the underwriter wished to please the broker. Valuers who are perceived to be "difficult" may find that their work is diverted to more accommodating colleagues or to rivals.

Opinions as to value differ. Valuation is more of an art than an exact science. The law normally allows a valuer a range of legitimate opinions or a reasonable margin for error. These values can be expressed as a percentage deviation from the hypothetical true value. The range of permissible values is often called "the bracket". The bracket is sometimes thought to be 10% either way but the law does not recognise any fixed percentage deviation. It depends on many factors such as the property, the area the property is located in and the date of the valuation. Astute valuers have a good idea how much "wiggle room" they have for a particular property before they can sensibly be accused of negligent or fraudulent valuation. This enables valuers to be "helpful" when necessary by valuing at the top end of the range. If the true market value is £250,000 the valuer can often get away with a valuation in the range £275,000 to £225,000 unless there are some very close or identical comparables at around £250,000. Valuers are aware that lenders who rely on their reports are normally only going to pursue them through the courts for negligent over-valuation, if at all, many years later and only where the lender has a clear legal claim and where there is a substantial over-valuation. Valuers know that in issuing over-optimistic valuations, they have little to fear by way of criminal prosecution. Valuers may get caught up in the general euphoria and come to believe that house prices can only go up or at worst plateau because of population pressures. A bit of an over-valuation will soon be covered up by price rises.

This brings us to consider one engine of house price growth during the boom where there was near unlimited availability of mortgage finance, high demand and historically low interest rates. A valuer is asked to value a new build flat. He finds comparables that have sold for £250,000. What he does not know is that the effective price was £230,000 with £20,000 paid in cash-back incentives to the

buyer. The house builder wants £260,000 for the flat and the buyer is willing to pay that amount, especially as he's expecting a 90% LTV mortgage loan from Sub-Prime. Well, with several £250,000 comparables and £10,000 well within the valuation wiggle room, why cause problems?

Valuers can be a powerful force in powering up home prices. Inflated valuations can ripple through a neighbourhood exerting upward pressure on prices. Highly inflated fraudulent valuations can flow like a tsunami through neighbourhoods distorting prices very significantly. Home owners notice that property prices are on the rise and jack up their asking prices. First time buyers may be squeezed out. Of course, in the crash, the process can work in reverse. In the long run, a systemic tendency to overvaluation in times of high mortgage availability and low interest rates damages the buyer, the lender and the community as a whole. This is particularly so when home owners believe that property price rises are permanent and accordingly borrow heavily against increasing home equity. Home buyers may repeatedly take further advances, re-finance their mortgages with other lenders or re-finance credit card debts or other unsecured credit against their home equity, greatly increasing their spending power and standard of living. When the inevitable crash occurs, many are left with negative equity, unaffordable borrowings and a greatly decreased standard of living.

SOME QUESTIONS FOR DEBATE

- Did lenders really pay enough fees to permit valuers to undertake high quality valuations? Were valuers pressed to undertake valuations too cheaply?
- Are valuers sufficiently regulated? They are far less regulated than lenders, mortgage intermediaries or solicitors.

BUY-TO-LET NEW BUILD FRAUD RINGS

If a fraud mastermind is able to recruit:

- Dishonest house builders willing to sell at a large overvaluation and return the over payment through the back door. Note: This back-payment would be larger than the incentives normally given by honest house builders.
- A crooked valuer prepared to issue fraudulently inflated valuations.
- A bent conveyancer (who may be a solicitor's employee, committing mortgage fraud without that solicitor's knowledge) to act for the buyer.
- Dishonest intermediaries such as crooked mortgage brokers willing to assist in submitting fraudulent mortgage application forms to lenders. Many of these intermediaries were authorised by the lender to instruct the valuer and nominate solicitors.

THEN the scene is set for industrial scale mortgage fraud. A number of variations are possible. Mastermind may purchase the units in a company controlled by him. The company will carry on business ostensibly as a normal buy-to-let landlord, letting to tenants, collecting rents and paying the monthly mortgage payments. Every time a new unit is purchased, mastermind will collect a large back-door payment from the house builder equivalent to the amount of the over-lending made in reliance on the fraudulent over valuation, less bribes and expenses. Mastermind may build up a large portfolio of units. His fraud may not be unmasked until house prices crash and falling rent-rolls lead to a default on the mortgages and the appointment of receivers by the lenders. The lenders will then find that the security is worth a lot less than they were led to believe by the valuer. Alternatively, heavily over-valued property may be off-loaded onto duped purchasers or investors.

A FRAUD RING AT WORK

Dodgy Builders are building several blocks of city centre flats in the north of England. Dodgy Builders' sales director meets Rogue, Shady Brokers, Crooked and Bent in the pub for lunch.

Rogue agrees to buy 150 flats in various cities in return for which the sales director agrees a bulk discount. The price of each flat is £200,000 but the sales director offers them to Rogue for £180,000 each. This is a reasonable market discount. The deal looks so good that the directors of Dodgy Builders, Shady Brokers, Crooked, Bent members of their families and even some of their employees take another 100 flats between them. Over a period of time, the ring buy the 250 flats at £180,000 each into various entities with high LTV bridging finance.

Dodgy Builders sells 3 flats to third parties for £275,000 each. One buyer is a relative of Dodgy Builder's sales director (but with a different surname), and two others are sold to offshore companies in the Caribbean which appear to have no connection with Dodgy Builders. They are in fact shell companies controlled by Dodgy Builders through nominee directors and shareholders. No money changes hands and the purchase price is left outstanding on loan account. There are no valuations. Bent acts on the conveyancing.

Shady Brokers arrange to re-finance the bridging finance with long term finance from Sub-Prime. Sub-Prime (in common with many boom-time market entrants) obtains almost all of its mortgage applications through brokers and is a little too anxious to keep in the brokers' good books. Sub-

Prime allows its introducing brokers to nominate the valuer and solicitor who will act for Sub-Prime in the grant of the mortgage. Shady Brokers nominate Crooked as the valuer and Bent as the solicitor. Crooked overvalues the flats at £275,000, citing the same-site dummy sales at £275,000 as comparables. Crooked also heavily overestimates the rent achievable. Sub-Prime agrees to an 80% LTV and advances £220,000 against each flat.

The ring pocket £40,000 per unit (£10,000,000 in total) less expenses.

When flat prices crash.....

LENDERS' RESPONSE TO NEW BUILD FRAUD

Lenders have taken a number of steps including the following:

- Some lenders have withdrawn from the new build market altogether.
- Reduced LTV's for new build.
- General tightening of policies and procedures.
- Automated fraud detection procedures.
- Use of valuer panel managers by mortgage packagers.
- Appointment of in-house valuers.
- Industry wide sharing of experiences and know-how.

A number of these items relate to all mortgage fraud, not just new build.

MORTGAGE APPLICATION FRAUD

Applicants and mortgage intermediaries sometimes tell lies to lenders as part of the mortgage application process. These lies can range from so called “soft fraud” such as exaggerating income on a self-certified income loan application to a fraudulent tissue of falsehood manufactured as part of a serious criminal conspiracy.

A mortgage intermediary may tell a prospective borrower that it’s necessary to tell a few “white lies” on the mortgage application form, but it’s “OK”, because everyone is doing it. A borrower might leave a partly completed and signed mortgage application form with a mortgage intermediary and leave the mortgage intermediary to ensure that loan product criteria are met. Otherwise law abiding citizens, who would never make a false claim on their home insurance policy, think it’s OK to lie to lenders because they intend to make the monthly payments.

A lie is a fraudulent misrepresentation intended to deceive or mislead the lender. Mortgage intermediaries know the lender’s product criteria. Putting the truth forward to the lender in the best possible light so as to meet the lender’s product criteria is both lawful and usual. Misrepresenting the facts is not. Lenders need to know the truth. If they don’t Lenders are cheated into making riskier loans than they planned for. Borrowers may dupe themselves into taking bigger loans than they can afford.

Let’s look at some examples.

SELF-CERTIFIED INCOME LOANS (“SELF-CERTS”)

Some borrowers are unable to provide normal documentary proof of their income. Those borrowers might be self-employed, temps, casual workers, seasonal workers, or freelance workers.

Self-certified loans were not designed in order to enable borrowers to obtain bigger or better mortgages by lying about their income. Unfortunately such lies, which amount to mortgage fraud, appear to have been made on a very large scale.

The borrower may well intend to make the monthly mortgage payments but find that they are unable to do so in the long run. This is a very common example of “fraud for property”.

TO OCCUPY OR NOT TO OCCUPY

Many borrowers, wishing to pay normal owner/occupier interest rates and wishing to achieve the highest possible LTVs, told lenders that they intended to occupy the property personally whereas they intended all along to let the property. The borrower will normally have every intention of making the monthly mortgage payments.

Occupation fraud has been going on for decades and will continue. Back in the 1970s, when buy-to-let loan products as we understand them had not been developed, a fraudster, with the knowing assistance of his conveyancer, purchased various properties with the assistance of loans from various building societies, pretending he was going to live in them himself. The fraudster intended to, and did in fact make the monthly mortgage payments. The fraud was unmasked when one building society sent someone around to value one of the properties for insurance purposes. Though the building societies lost no money, the scheme was still fraudulent and the fraudster and the conveyancer were sent to prison.

MIS-STATEMENT OF SOURCE OF DEPOSIT AND PURCHASE EXPENSES

The lender needs to know that the borrower has the right amount of “skin in the deal” otherwise the borrower’s commitment is weakened, the lender’s loan criteria are not met and the lender is placed at greater risk. The lender expects the borrower to have the deposit and the purchase expenses available in cash. Here are just some of the devices used to deceive lenders:

- The borrower has no deposit and will claim to have paid it direct to the seller.
- The deposit is borrowed from relatives or friends.
- The seller’s funds the buyer’s deposit against an inflated purchase price.
- The “silent second charge”. The borrower arranges to borrow the deposit and purchase expenses from a third party. The arrangement is not disclosed to the lender. After the lender’s charge is registered, the second charge is quietly registered. Such a scheme might be operated by an unethical conveyancer with close links to a private, unethical and possibly usurious lender – perhaps the unethical conveyancer wearing another hat. This practice is more difficult than once it was as first charge lenders now often place a restriction on the borrower’s title at the Land Registry preventing the registration of second or subsequent charges without the first charge lender’s prior written consent.

IDENTITY FRAUD

The borrower may be a straw buyer with or without a false identity and address.

The borrower may be entirely fictitious i.e. a fully synthetic borrower.

The borrower may be a foreign national or a family relation with or without a false identity.

The borrower may be a real person whose identity has been stolen.

FAKING EMPLOYMENT AND INCOME

Accountants sometimes provide false income references.

A borrower gets a friend or relative who owns a business to claim that the borrower works there and give a false income reference.

A borrower creates false employment and pay documents. Very easy with readily available software.

Internet sites provide various services to verify employment including fake pay documentation, fake employment verification letters and in the United States even phony phone verifications.

SHARING CREDIT HISTORIES

In the United States it’s supposedly possible to boost a borrower’s credit score up to the level required by the lender’s particular product by adding the borrower’s name to a credit card of an obliging third party with a good credit history and a high credit limit. Sometimes the borrower’s name is added to several cards. The borrower does not of course enjoy signing rights. The borrower provides a credit-sharing intermediary with a suitable fee for this service. The lender is not told how the credit score has been boosted.

ADDING A SOLVENT RELATIVE THE TITLE AND MORTGAGE

- A relative with suitable income or assets (e.g. a parent) might be added to the application with a false claim that the relative will live at the property.

CHECKING THE MORTGAGE APPLICATION

Lenders don't blindly accept all information provided by borrowers. They check and verify to a greater or lesser extent. That process is beyond the scope of this paper. Sometimes it's obvious on first reading that something is amiss. Here are some examples:

- Distance from property to borrower's place of work is too great. This suggests that the property is not being purchased as a primary residence. May indicate occupation fraud.
- Inconsistent, illegible or misspelled signatures on file. Perhaps a straw buyer.
- Years of employment inconsistent or impossible based on borrower's age e.g. 21 year old borrower has been employed for 7 years.
- Employer's address is a post box.
- Employer's name is similar to borrower's name.
- 19 year old hairdresser in small country village claims £55,000 annual income in self-certified application.
- Assets inconsistent with income. Claimed income is high but negligible assets.
- Claimed assets are high but income looks too low.
- Incomplete application details. Something to hide?
- Borrower claims to be employed but work number is identical to home or mobile number. Indicates self-employment.
- The applicant claims to have an unlikely large deposit.
- Applicant deliberately fails to disclose previous address information as there is adverse financial information connected with that address.

NATIONAL HUNTER

The National Hunter system is an anti-fraud data sharing system for use by members of the Financial Services Industry. It was founded in 1993, with the assistance of the CML. National Hunter Limited is an independent not-for-profit company and is solely concerned with the prevention of application fraud within the Banking and Finance community. Each of the members submits details of applications that they receive for products such as mortgages, credit cards, loans etc.

Applications are checked against existing applications for inconsistencies and similarities that may indicate application fraud using a predefined set of rules. Any applications that warrant investigation are referred for further checks. National Hunter state that no applications are automatically declined on the basis of National Hunter information and all their members are fully audited on their use of the system on a regular basis.

The National Hunter system is operated by Experian Decision Analytics, part of the Experian group.

SIRAN

Launched in 2006 Equifax's SIRAN anti-fraud system includes the ability to search on-line for fraudulent applications, suspicious patterns of data and fraud rings.

MORTGAGE INTERMEDIARIES

The mortgage intermediary industry deserves a special mention in any analysis of mortgage fraud. Mortgage brokers, packagers and introducers comprise a link or chain of links between the applicant and the lender. I will refer to them all as “mortgage intermediaries”. During the house price boom mortgage intermediaries fell somewhere along a spectrum ranging from “highly respectable” to “cowboy”. The cowboys misbehaved dreadfully.

I will now describe some of the activities of unscrupulous mortgage intermediaries.

At the lower end of the scale some brokers not only took a large introduction fee from the lender plus over-riders but they also charged a big fee to borrowers and took insurance commission from products such as payment protection insurance. They also took backhanders from valuers and solicitors and anywhere else they could.

Unscrupulous mortgage intermediaries were not particularly concerned with truth or reality. They knew how to add and/or deduct information from a mortgage application (that may or may not be provided by an applicant) in order to present a case to a lender that met the lender’s criteria. Poor credit history was concealed. Income was exaggerated. Misconduct was recommended. If an applicant did not have a deposit, the mortgage intermediary might suggest that the applicant claim that the deposit is being “gifted” by a relative. In one case concerning a block of 12 flats, there were four mortgages where each of the four had a deposit “gifted” by a relation. The broker constructed an identical letter of confirmation to each of the four lenders for each of the four applicants for each of the four different relatives.

Unscrupulous mortgage intermediaries have created or turned a blind eye to fictitious passports, artificial payslips and every kind of fiction and falsehood that computers and artists can produce, to facilitate impersonation and deception. They also teemed up with criminal fraud rings including fraudulent valuers, conveyances and developers.

There have been very few instances of lenders bringing actions against mortgage intermediaries for fraud or negligence.

AIR LOANS

Aircraft finance? Sadly not. An air loan is a loan made on the basis of thin air. The loan advance has gone but the borrower, property, intermediary, verification documentation – everything is false. Air loans seem to work best with stolen identities.

Air loans might be originated by:

- A fraud mastermind unconnected with the lender.
- An officer within the lender, often to provide unauthorised personal bridging finance.
- A lender in order to generate cash by selling non-existent loans to loan investors or into securitisation. This practice has been reported in the United States.

DOUBLE SALE FRAUD

A first cousin to the air loan is the “double sale” where the same loan is sold or securitised twice. The double sale is more difficult to detect than the air loan as the fraudulent second sale is based on a legitimate borrower and real home held as security. There is no suggestion that these practices take place in the United Kingdom, though double sale is a recognised fraud-type in the United States.

DOUBLE MORTGAGE FRAUD

This one of the many types of mortgage or property fraud that a conveyancer can perpetrate alone. I will give an example. A house is purchased with the help of a mortgage loan. The mortgage is registered only against a small part of the property, perhaps four square feet at the bottom of the garden. The lender is likely to be deceived into thinking that the security covers the whole property. If, after completion, someone in the lender’s deeds department picks up the discrepancy, the conveyancer discovers a “mistake” and – sorry, we attached the wrong plan. The error is rectified. If the lender does not pick up the discrepancy, the unmortgaged house (minus the mortgaged four square feet at the bottom of the garden) is mortgaged to a different lender a few weeks later and the advance is pocketed.

INVESTMENT SCHEME SCAMS

These schemes may combine real estate fraud with mortgage fraud. The schemes depend on establishing trust. They are “Crimes of Persuasion”. In the United States this type of fraud is called “Chunking”. Let’s consider investment scheme scams in the context of new build buy-to-let.

Involvement of a house builder or buy-to-let is not necessary. Rogue can source homes on the open market perhaps specialising in repossessed property. A fraudulent scheme could involve properties suitable for holiday lets. Rogue may “flip” the property to investors (probably via a company controlled by Rogue) at a substantial up- front profit.

How does Rogue find the investors? Here are some examples:

- Presenting a property investment seminar.
- Running advertisements.
- Personal acquaintances.
- Forming a “property investment club”.
- Affinity fraud. Infiltrating an organisation, obtaining money from and selling fraudulent schemes to members after gaining their trust. Victims may be the elderly, ethnic groups or religious groups. “I’m one of you, I can help make your dreams come true”.

Rogue, a charismatic fraudster presents an attractive buy-to-let investment off-plan. It’s new city centre block of flats in the north of England being developed by Dodgy Builders. In a very simple fraud, Rogue collects “initial investments”, say £5,000 from each investor and disappears. Life is rarely that simple.

In a more complex scheme, Rogue may represent that:

- Buy-to-let is a wonderful, can’t fail investment. Prices will keep going up and investors should get on the bandwagon now. City centre flats are a particularly good investment because that’s where lots of people need rented accommodation. Rogue plays on the greed and naiveté of investors, and the general euphoria about house prices.
- Investing in property can be tricky and time consuming but Rogue will “take care of everything”.
- Rogue can obtain a 10% price discount from Dodgy Builders.
- Rogue will obtain the mortgages through Shady Brokers.
- Rogue will obtain the tenants. Rogue overstates the expected rents.
- Rogue will undertake all management, dealing with lenders and tenants, collecting rents and paying the monthly mortgage payments. In fact, Rogue has no property management skills.
- Rent will cover mortgage payments, flat ground rents, insurance and service charges and there will be a little bit left over each month for investors.
- With increasing house prices, a large capital gain will be made when the units are eventually sold.

Exactly what happens next can vary. Rogue may pay out high returns to early investors using money from later arrivals (see Ponzi scheme below). The first investors may be highly enthusiastic and innocently help sell the scam to others. Here are some possibilities:

- Investors buy overvalued properties with big mortgages from Sub-Prime arranged through Shady Brokers. Sub-Prime allows Shady Brokers to nominate the valuer and the solicitor. Shady Brokers nominate Crooked as the valuer and Bent as the solicitor.
- Dodgy Builders pay a secret cash kick-back to Rogue for every unit sold.
- Bent, the solicitors act for most of the investors on the purchase – especially as Dodgy Builders has agreed to pay investors’ legal fees if they instruct Bent. Investors are pleased with Bent’s service. The whole purchase process is so quick and smooth. Bent doesn’t encounter any of the delays or difficulties that honest solicitors seem to be prone to.
- Few if any tenants materialise. Monthly mortgage payments quickly fall into arrears.
- Investors discover that the road traffic visibility splay at the front entrance to the property has not been built in accordance with the relevant planning permission. The core staircases do not comply with fire regulations. There is a problem with the rear access. It seems to pass over a small strip of land not owned by Dodgy Builders.
- The flat block deteriorates. Some flats become occupied by vagrants, drug dealers and sex workers, or are just trashed by vandals.
- Dodgy Builders goes into administration. Many flats do not pay their service charges and services disintegrate. The lifts don’t work and the common parts are not cleaned.
- There is a fire in one of the flats but the insurers won’t pay out because the flat was unoccupied.
- House prices crash. Investors discover that they bought the flats for almost twice their real market value. Flats, if they can be sold at all, sell at a huge loss, giving rise to crushing mortgage shortfall liabilities.
- Rogue is on a warm, sunny, remote island with his new girlfriend and has not left a forwarding address.
- Lenders re-possess the flats. Investors, some having invested their life savings, are ruined.
- Investors’ credit rating is ruined. Their lives disintegrate under the weight of debt.
- Some investors claim that when they signed the mortgage documentation, they did not realise what they were signing owing to Rogue’s misrepresentation.
- The police are called in – but that won’t bring back the investors’ money or the lenders’ money. Rogue will never, as we say, “grip the rail” at the Old Bailey.

The investors form an action committee and instruct solicitors. Crooked the valuer and Bent the solicitor are still around. They are both insured against negligence for substantial sums. Insurers don’t insure Crooked or Bent against fraud, but if Crooked or Bent have innocent partners in their respective practices, those partners can be sued for Crooked and Bent’s fraud and will normally be covered by their professional indemnity insurance policies. As fraud is more difficult to prove, and there is a risk with insurance cover, the investors sue successfully Crooked for negligent over-valuation.

Bent’s files, seized by the police, don’t provide enough evidence to establish fraud, partly because Bent filleted them before the police arrived and partly because pay-offs and cash-backs were paid via an offshore account in the British Virgin Islands and not via Bent’s client account.

The files do however reveal the following:

- Bent was in Dodgy Builders' pocket and acted more in their interests than in the investors' interest. Certain conflicts of interest arose and Bent improperly failed to protect the investors' interests. The investors sue Bent successfully for breach of fiduciary duty.
- In this particular case Bent was negligent in failing properly to check compliance with town planning requirements (the visibility splay) and good title to the rear right of way. The investors sue Bent successfully for negligence.

Claims against professionals for negligence, breach of duty or fraud can be complex.

INVESTMENT SCHEME SCAMS MAY CONTAIN ELEMENTS OF A PONZI SCHEME

Around 1920, Charles Ponzi (the former Carlo Ponzi, an Italian immigrant to the United States) promised clients a 50% profit within 45 days, or 100% profit within 90 days, by investing through his company in the purchase of discounted postal reply coupons in other countries and redeeming them at face value in the United States. Postal reply coupons allowed someone in one country to send the coupon to a correspondent in another country, who could use it to pay the postage of a reply. The coupons were priced at the cost of postage in the country of purchase, but could be exchanged for stamps to cover the cost of postage in the country where redeemed; if these values were different, there was a potential profit. This is a type of arbitrage.

The scheme provoked an investment feeding-frenzy. Money poured into the scheme in astonishing amounts. Early investors were paid their return. Many re-invested their profits. It is said that investors mortgaged their homes and withdrew life savings to invest - does this sound familiar?

There was a small problem. The scheme wasn't profitable. Dividends were paid not from profits but from the incoming investment cash flow. That's what a Ponzi scheme amounts to. Someone noted that to cover the investments made with Ponzi's company, 160,000,000 postal reply coupons would have to be in circulation. However, only about 27,000 coupons were actually circulating. The scheme collapsed, investors were ruined and Ponzi went to prison.

Ponzi fraud bears some resemblance to the fraudulent accounting practice known as "lapping" or "teeming and lading", used to conceal theft of cash by a cashier or clerk. Lapping occurs when a cashier or clerk steals cash from one customer's payment and conceals the theft by stealing cash from the next customer's payment ... and so on.

CONCLUSION

THE NEED TO FIGHT MORTGAGE FRAUD

Mortgage fraud is a dangerous and insidious crime which damages individuals, businesses, communities and society itself. It is not a victimless white collar crime. Far too few law enforcement resources are available to counter it. During the boom, mortgage fraud was generally a low priority for police forces, in part because the sheer scale of the problem was understandably not recognised until unmasked by the crash. Also, guns, knives, violence and other “high fear” activities are not involved. The greatest exception is the City of London Police, who wage a valiant and sophisticated campaign against high-end mortgage fraudsters. I hope the government will provide the police with substantial extra funds, at the very least to enable them to fight effectively serious, criminal, organised mortgage fraudsters.

THE NEED FOR GREATER PUBLIC AWARENESS OF MORTGAGE FRAUD

There is a need for greater public awareness of mortgage fraud so that potential victims have a greater chance of protecting themselves and of recognising and reporting criminal activities to the authorities.

DID MORTGAGE FRAUD TRIGGER THE GLOBAL FINANCIAL COLLAPSE?

I have explained earlier in this paper how mortgage fraud can artificially inflate house prices. In my view, the over-valuation and over-lending associated with mortgage fraud was one of the principal engines powering the incredible and unsustainable inflation in house prices in both the UK and the US in the 21st century. The global crash was triggered (but not entirely caused) by the realisation that US lenders, and those who had purchased securitised sub-prime debt originated by them, would make heavy losses. I suspect that many of those losses can be traced back to a number of the fraudulent activities described in this paper. So much so that it may eventually be determined that US sub-prime losses originated not in US sub-prime lending *per se* but in mortgage fraud in US sub-prime lending on an unprecedented scale. Without mortgage fraudsters we might have escaped the crash or at least such a serious downturn.

Clive Whitfield-Jones

Solicitor, Partner Jeffrey Green Russell

Jeffrey Green Russell's Mortgage Recovery Services

We serve mortgage lenders in many ways.

MORTGAGE REPOSSESSION

Our mortgage repossession team combines many years of experience with advanced technology to provide you with a highly effective volume mortgage repossession service.

SALE OF REPOSSESSED PROPERTIES

We integrate seamlessly the sale of repossessed properties in our repossession process. Our team deals with any security or conveyancing points that may arise, the discharge of the mortgage and advises on the distribution of any surplus.

BUY TO LET

We are instructed by national lenders in buy to let collections and repossessions. We advise on the host of problems that these cases can involve, including:

- LPA receiverships.
- Tenancies and tenant rights.
- Obtaining vacant possession from tenants.
- Mitigating lender's obligations to tenants.
- Rent arrears.
- Legal liability and cost re-imburement for repairs, state and condition.
- Non-cooperating borrower landlords.
- Unauthorised tenancies and other occupiers.
- Missing tenancy documentation.

LPA RECEIVERSHIPS

Where property is tenanted, Lenders often wish to avoid taking possession as this may expose them to:

- potential civil and criminal liability as effective landlord.
- the usual obligations of a mortgagee in possession.
- management headaches they are not geared up to handle.

We deal with all legal aspects of LPA receiverships including appointment, validation of appointment and exit.

EVICTION OF TENANTS

This service is important to Lenders, particularly with buy-to-let properties and unauthorised lettings of supposedly owner occupier property.

MORTGAGE FRAUD AND PROFESSIONAL FRAUD

A specialist unit deals with mortgage fraud by borrowers and professional fraud which may involve solicitors, agents, valuers or brokers.

PROFESSIONAL NEGLIGENCE

We seek redress for Lenders where surveyors, valuers or solicitors may have been negligent. Conditional fee agreements backed by after the event insurance are available to minimise Lender's litigation risk exposure.

SOLICITORS COMPENSATION FUND CLAIMS

We advise on and prepare claims on the Solicitors' compensation fund.

SHORTFALL RECOVERIES

We arrange tracing of the borrower and assessment of means. We attempt to negotiate a sensible settlement. In appropriate cases, assets or income may be traced or attached and bankruptcy proceedings taken.

DEFECTIVE SECURITY

We assist Lenders to remedy defective security so as to facilitate repossession and sale.

RELIEF FROM FORFEITURE OF LEASES

Rapid action is necessary to protect mortgages of leasehold property where landlords take forfeiture proceedings. We negotiate with Landlords and, if necessary, take court action to preserve security.

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