Fannie Mae

Beyond the Guide

Section 4

Red Flags, Fraud Detection, and Managing Risk Tools

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One of the objectives of QC is to identify and reduce fraud and misrepresentation that can occur with any loan purpose or type.

Red flag awareness is needed throughout an organization – from strategic and broad scale (digital testing of entire book) to tactical (loan-level). Staying alert for red flags through multiple methods and tools is critical. Red flag identification should be part of both post-closing and prefunding QC (PFQC) processes, but PFQC is uniquely positioned to support production teams in identifying and remedying these defects.

Red flags are not just something listed on an automated underwriting system or credit report or even a mortgage fraud screening tool. A red flag is *"something that indicates or draws attention to a problem, danger, or irregularity"* (Merriam-Webster – definition as noun). Irregularities can take many forms.

Strong QC programs assess all files for any irregularities to determine both the materiality and the cause of each irregularity. Such causes include human error, process gaps, data irregularities, misinformation, misrepresentation, and/or fraud. Human errors are likely to be isolated. Irregularities can be surfaced through use of digital technologies (fee or no-fee) or simply by comparing similar data in various locations throughout the loan file (e.g., borrower Social Security number is consistent on all documents in the loan file). Misinformation can be corrected through confirmation. However, multiple instances of error and misinformation may indicate misrepresentation or fraud.

Consider the various methods available for detecting red flags:

Red flag detection sources

Automated systems	Data validation tools	Manual observations/ validations
Desktop Underwriter® (DU®)	Fraud detection software	Reviewing documents for inconsistencies
Collateral Underwriter® (CU®)	Pattern recognition software	Written or verbal reverification of information
Credit Reports	Data validation/ reconciliation software	Online search engines to identify corroborating information

Considerations

- Consider tracking and trending observed red flags to look for patterns – all red flags that are cleared should be documented, including how they were cleared and red flag source (e.g., production channel, parties to the transaction, red flag types).
- All discrepancies should be adequately addressed and not assumed to be "just an error."
- Documentation provided to address discrepancies should be reviewed with extra scrutiny.
- Perform a final overall loan assessment after completing all validation checks to ensure the loan makes sense in its entirety.

New risks and solutions in a digital world

Every day more of our business is conducted in a digital environment. Digital tools that have been in the marketplace for years, such as optical character recognition, are being upcycled and paired with artificial intelligence for new uses in the mortgage industry. Many loan origination systems capture digital information so that conveniences such as e-signatures and digital verifications of income, employment, and assets can yield efficiencies for both lenders and consumers. However, these new environments present new risks and challenges that organizations should respond to.

What are some types of digital information that QC can validate/monitor?

Borrower email address	Are emails from the borrower coming from the email address provided on the loan application? Is the borrower's email address consistent throughout the file?
IP addresses	If available, compare borrower public IP address to current location and subject property location to identify discrepancies.
Accuracy of third-party calculations	Are digital calculations performed by third-party tools being performed correctly? Periodic testing of calculations can reveal contradictory and conflicting information.

Considerations

- Be on the lookout for digital solutions that can enable QC to be more effective (think automated fraud tools). Watch for new solutions to automate lower-risk data accuracy elements, leaving human resources free to perform more complex reviews.
- CAUTION: Digital solutions also have limitations – it's imperative that lenders know and control for those limitations! Think of adaptive cruise control on cars. This technology can maintain safer cruising distances or brake faster, but drivers still need to keep their eyes on the road. Over-reliance on any technology solution can cause more harm than good!
- Keep up with new or enhanced digital solutions deployed within operations – adjust testing as needed.

Be on the lookout for digital solutions that can enable QC to be more effective. Watch for new solutions to automate lower-risk data accuracy elements, leaving human resources free to perform more complex reviews.

Tools for the job

Leveraging technology tools can be an effective way of identifying risks in your book of business. Examples of tools include various mortgage industry fraud detection tools, Fannie Mae's CU, and lender-developed proprietary tools for scrubbing internal data. Using tools such as these to surface red flags and elevated risk can be helpful to identify loans that should be sampled. Other tools exist that can also be helpful, but to ensure you are selecting the best tools for your organization you should develop a method for selecting, testing, and monitoring the efficacy of the tools you use.

Considerations for effective implementation and use of tools

Effective implementation of automated risk tools requires a thoughtful approach. Below are some thoughts that should be considered when implementing a new tool or evaluating an existing tool:

- Maximize the effectiveness of any automated risk and data-screening tools by ensuring, when possible, they are deployed across all loan production.
- Automated risk and data-screening tools complement, but do not replace, a comprehensive prefunding QC program.
- Ensure any automated tool is customized for your company's desired controls before use. Out-of-the-box settings typically do not align with a lender's unique risks.
- The output of your tools should promote action that reduces a "check the box" approach.
- Consider integrating your tools into your loan origination system. Integration creates an opportunity for strategic loan selections and system hard stops for loans with defined eligibility, compliance, or fraud flags.
- If automated hard stops are not possible, implement a funding condition or post-funding review process to ensure loans with unresolved eligibility, compliance, or fraud flags do not get delivered to investors.
- Define clear escalation paths for when the tool identifies flags or alerts, including individual management-level authorities.
- Ensure reporting, evaluation, and oversight of tools are independent of the origination and underwriting staff.
- Monitor false positive levels for tool efficiency. Adjustments to testing parameters should be considered to ensure the proper balance between defect identification and false positives.
- Tools can fail or have gaps. Continuous monitoring of results may reveal deficiencies and highlight opportunities for tool enhancements and improvements. Continue to think of ways the tool can fail and how to fill those gaps operationally.

When utilizing a tool(s), it is important to understand each tool's strengths and weaknesses and where gaps or blind spots may exist. This will ensure the right tool is being used for the intended purpose.

Resources

Fannie Mae's Mortgage Fraud Prevention page