## OriginationNews For Mortgage Brokers, Correspondents, Lenders and Wholesalers

## Eyeing Two Options for Mitigating Fraud Risk

## BY LEE A. BRODSKY

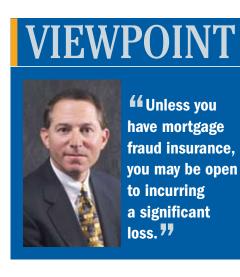
*Mr.* Brodsky, president of the Chicago-based Mortgage Banking Insurance Group of JMB Insurance, has written an opinion piece on what he sees as differences between a fidelity bond and mortgage fraud insurance. His thoughts on the topic are presented as this month's Viewpoint.

t probably comes as little surprise that mortgage fraud is on the rise. In fact, the FBI recently announced on its website that its mortgage fraud investigation caseload had jumped 47% from 2006 to 2007. Troubling? Yes. But, a surprise? Not these days.

On the other hand, what may catch you off guard is the fact that unless you have mortgage fraud insurance, you may be open to incurring a significant loss. It's at this point that most people ask, "What about my fidelity bond? Won't that protect me from mortgage fraud?" Only in certain circumstances.

This opens up questions about what a fidelity bond covers, what mortgage fraud insurance covers and why both are needed. To clear up this confusion, I've answered some of the questions I'm commonly asked.

What does my fidelity bond cover? Fidelity bonds insure against losses due to employee dishonesty. While all carriers have their own definition of "employee dishonesty," a general definition for it under a fidelity bond is dishonest acts by any employee, whether acting alone or in collusion with others, committed with the manifest intent to cause a loss and to obtain improper personal financial gain. For further clarification, the definition specifically



states that improper personal financial gain does not include things such as salary, fees, commissions, bonuses, etc. So fidelity bonds do not cover all types of dishonesty and fraud, just those in which an employee — either acting alone or in collusion with others — was involved and had an improper personal financial gain.

Why do I need fidelity insurance? Freddie Mac, Fannie Mae, Ginnie Mae, private investors, warehouse lenders and some wholesale lenders all require it. They also require mortgagee's errors and omissions and theft of investor's collateral if the firm is privately held. Together the three make up the core of your mortgage bankers bond.

You should also look at your company's own exposure. The investor's requirements are often lower. Case in point, Fannie Mae bases its fidelity and E&O insurance requirements on servicing volume. Therefore, if you originate much higher volumes than you service, you could be well underinsured even though you're meeting the requirement.

On the other hand, Freddie Mac takes into consideration your servicing and origination volumes and bases its fidelity and E&O insurance requirements on the higher of the two. So, if you originate a higher volume than you service and you are Freddie Mac approved, Freddie's requirements will have you better covered.

What does mortgage fraud insurance cover and what are the benefits? If a loan defaults and an investor discovers the loan was originated fraudulently, the investor is going to require you to repurchase the loan. Mortgage fraud insurance was developed to protect originators from such a large out of pocket expense.

The insurance also carries with it a number of loss protection services. Key among these is the inclusion of legal services to investigate and pursue the mortgage fraud. The loss mitigation team will work to track down fraudsters to help recover the capital. Other services include operational assessments, employee training, fraud awareness and ineligibility lists, which state companies and individuals whose involvement in a mortgage transaction is viewed as an increased risk.

How do I get approved for mortgage fraud coverage? In order to be approved for the coverage, you'll need to comply with certain operational controls and industry best practices, which are mandated by the carrier but similar to those already required by investors. In addition, the carrier will review such risk factors as prior fraud loss experience, production volume, product type, distribution channels, pre-funding guidelines and geographic dispersion.

It should also be noted that if a claim results, the carrier will actually look back at how you handled that particular loan. If you followed the mandated steps, the coverage will respond. If you didn't ... well, you'll end up learning a very expensive lesson.

What demands must I meet for a fidelity bond? Much like mortgage fraud coverage, fidelity carriers require that you follow certain procedures and will have you sign off on those procedures during the application process. The difference is that if there's a claim under your fidelity insurance, your carrier will not necessarily evaluate how you handled a particular loan unless they discover a "material misrepresentation" in the application for the insurance. If a claim is covered, the insurance policy will respond on your behalf without verifying controls.

However, if you are unfortunate enough to

have more than one claim under your fidelity bond, the carrier will start asking a lot more questions. Particularly, they will want to review where your controls are breaking down and see if you have resolved the problems.

If the review is negative, the carrier may decide you are no longer an insurable risk and either cancel or non-renew your coverage. That will make it extremely hard to find another carrier to now take on your coverage.

Along these same lines, I've had people ask me if they should "bend the truth" on certain details about their firm in the fidelity application. For instance, "should I downplay the number of subprime loans we originate?" Again, if you have a claim and the carrier discovers your lie (and the lie is considered "material misrepresentation"), they'll rescind the coverage and not cover the claim. So, yes, you may end up with better rates for the time being, but if the carrier discovers your misrepresentation, they might refuse to honor claims.

Is there any overlap between these two coverages? Under the fidelity bond, there is some coverage for mortgage fraud. For example, if an employee is in collusion with others to commit mortgage fraud, the resulting loss would likely be covered by your fidelity-insuring clause. Some carriers may even let you extend the definition of employee to include attorneys performing loan services, loan closing agents and servicing contractors. Nonetheless, fraud on the part of the borrower with no inside help on the part of an employee is likely not covered unless the fraud involves forged real estate documents.

That leads us right to another potential overlap. Mortgage fraud insurance and your fi-

delity bond, if it has been extended to include forged documents, may both cover a situation in which the documents you relied on to approve a loan were actually forgeries. Once again, the fidelity bond's "forged documents" coverage only goes so far. Forgery involves signing someone else's name or materially altering a document with the intent to defraud. If an individual signs his own name to a fraudulent document (such as in the submission of a false tax return or in a straw buyer scam), a forgery hasn't occurred, so the forged documents coverage won't cover your losses. While this overlap only affects a very small portion of the wide range of fraud cases, it's important you understand how the individual coverages react should one of these situations occur. Often policies include an "other insurance" provision. This provision states that if another policy has been taken out covering duplicate exposures, the other policy is responsible for any claims. If both policies have this provision, they could cancel each other out leaving you completely exposed. Your broker should be on the lookout for these sorts of issues.

**Couldn't I save a lot by just meeting requirements?** Someone recently told me that in five years they've only had one repurchase. So, by not having mortgage fraud coverage, they saved a lot of money. Another person told me they had a lot more repurchases than expected. They also hadn't purchased mortgage fraud coverage, but wish they had. The truth is you just don't know if you're ever going to have a claim. But, if you think premiums are bad, just imagine the unbudgeted expenses resulting from incurring an uncovered loss. **0**