National Mortgage PROFESSIONAL Magazine
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A New Era for Mortgage Closings?

Replacing the Closing Protection Letter with Independent Vetting Standards and Uniform Comprehensive Insurance Coverage

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Hardly a week goes by that we are not hearing about some type of fraud, scam, or escrow theft in the real estate and title insurance/settlement services industries. How do we protect ourselves from being a victim of one of these events? There is the old adage that you cannot protect people from themselves and their bad decisions. That is true when anyone of us listens to a "too good to be true" story, or a promised rate of return you would be a fool to pass up.

However, not one of us should be a victim of escrow/closing table theft by a title insurance agency. And if we were the victim of such a theft, why isn't there any insurance protection? After all, most of us use a title insurance agency for the real estate closing on a sale or a refinance transaction. Aren't these agencies regulated by the government? The answer to both questions is yes! There is insurance and escrow regulation - - in some states it is ineffective - - in some states, nonexistent when it comes to protecting you from escrow theft.

The insurance departments in most states license the title insurance agent and a lesser number of states have escrow licensure. Licensure is the minimum threshold for entry into a business where relatively unknown individuals handle hundreds of millions of dollars of "other people's money." There are basic licensure background checks and fingerprinting, but very few applicants are rejected unless the applicant admits to a prior felony conviction for dishonesty. Consequently, thousands of people in the settlement services industry must be bad actors or persons influenced by bad actors or we would not be experiencing escrow thefts.

The settlement industry has but one option – it must purge the industry of these bad actors and implement systems to prevent new bad actors from becoming part of the industry. If the industry fails to act aggressively, then state and federal regulators will step in. The industry's vetting process for agents has not proven to be adequate. The underwriters are losing millions every year in escrow thefts and the numbers are increasing every year.

Independent and Objective Validation is Necessary

One immediate option is an independent and objective vetting process for the individuals responsible for escrow disbursements. The independent vetting entity

is objective because the process looks at the background and credit history of the individual and the vetting entity's analysis is not influenced in any manner by the past or potential business contributions an individual could bring to an agency. Further, objective vetting is not static --as of a certain date, everything with "Individual A" is good. The new vetting process is constant- new information is continuously integrated into a database and the database is accessible to the financial institutions 24/7/365. This is all critical information regarding an individual's current conduct because current conduct will disclose activity that may reflect an inclination for theft or reflect an unusual demand for money. Once this information is available to the agency owners, financial institutions and underwriters they will then be able to closely monitor the individual's activity and potentially prevent theft.

As a former insurance regulator, I have witnessed firsthand the devastating consequences of escrow theft. Adding to the misery of their funds being stolen, most victims must litigate for the return of their funds because, in most states, the title underwriters are not responsible for the escrow operations of their agents. Mortgage fraud and escrow thefts involve many of the same elements. Financial institutions have spent billions of dollars on the front end of the loan process to prevent fraud. Now, the settlement industry must invest in its business model to prevent escrow theft or closing table theft on the back end of a transaction. Rather than complain about being over regulated-- regulation that has not even come close to solving closing table theft; look at the real problem! The consumer is at risk and everyone else, including the Consumer Financial Protection Bureau, is looking out for them. Now, right now, the settlement services industry must clearly demonstrate that the agencies and the people in the industry are not just sufficiently competent and capable to handle the transaction, but most importantly, this is an industry that can be trusted with other people's money. Independent vetting is a validation.

Vetting and Risk Rating Provide Tangible Benefits for Agents

If you are one of the good guys, independent vetting is one of the best investments you can make in yourself and your agency. First, you are validated as a trustworthy individual. Second, your bad actor counterparts will not be validated and hopefully will be driven from the business. Both result in additional business opportunities for you. Make the investment in independent objective vetting and you will drive the bad actors out of your industry. Let's take a detailed look at the problem.

For years now the mortgage and real estate closing process has been largely viewed by some banks and settlement professionals as nothing more than a glorified signing party. Concerns about fraud, infidelity and negligence on the part of those handling mortgage proceeds and bank documents and the other professionals who play a part in the settling of a transaction have been largely ignored. This has been true despite the fact that the concept of wiring funds to a closing agent who is largely unknown and allowing strangers to handle mortgage documents and disbursements without uniform standards seems counter to prudent business practices.

Today title underwriters, who have been primarily self-insured on their direct operations, have seen claims rise, profits dwindle, and lawsuits by lenders and consumers stack up at courthouses around the country. In addition, the underwriters have also experienced increased claims, reduced profits, and lawsuits from the independent agency operations. Consequently, any notion that title underwriters will continue to allow agents to bind them for acts of negligence and infidelity by closing agents requires radical readjustments and new thinking.

Likewise mortgage lenders and consumers cannot continue to rely upon the closing protection letter ("CPL") as a form of insurance against losses from mortgage fraud and escrow theft because it is not an insurance product. The CPL offers very limited coverage for losses. Quite frankly it is time for the title underwriters and their issuing agents to get out of the escrow insurance business and for lenders to utilize third party sources for underwriting and insuring risks at the closing table.

It's All In the Numbers

Anyone connected to the mortgage and real estate industries is familiar with the numbers, but they are worth a reminder. The FBI has called mortgage fraud the number one white collar crime in America after terrorism. The FBI has allocated more agents nationwide to investigating escrow fraud than any other white collar crime. In 2011 the FBI reported $11 billion in mortgage fraud losses from SARS filings, and for 2012 the number is estimated to rise to $13 billion. The FBI estimates that 15% of those losses are directly attributable to escrow and closing fraud. These figures appear to be supported by the Financial Crimes Enforcement Network (FINCen) July 2012 study of SARS reports between 2003-2011 which indicated that there has been unacceptable growth in fraud losses in the escrow and

closing area, with a 20% increase in the most recent period.

According to statistics published by the National Association of Realtors and Mortgage Bankers Association, there are 8.5 million mortgage closing transactions annually, with the average loan size approximately $175,000.00. Each of these loan transactions requires a closing attended by a settlement agent, so that means that in 2012 lenders will have delivered more nearly $1.5 trillion dollars (and the collateral security documents to establish their legal right to repayment) into the hands of a virtually unregulated industry.

Yes, There Really is Fraud at the Closing Table

While fraud can take place in any part of the loan process, lenders are most at risk at the closing. Settlement agents, who are responsible to disburse the lender's money, to supervise the execution and delivery of the deed, note and mortgage instruments, are traditionally subject to little or no scrutiny. Escrow licensing, while important as a barrier to entry into the profession, it is not risk management. There is not one license that covers all of the various actors who handle funds and documents during a closing which, depending upon the state or region, includes lawyers, escrow agents, title agents, lenders, closers and realtors.

The current vetting by title underwriters and some banks is primarily static. It is not ongoing, it is not uniform, it is generally focused on entities, and does not involve the sharing of data nor is that data maintained in a user accessible database. You need only review of the FBI fraud statistics and the Mortgage Fraud Blog to realize that whatever is being done now is not adequate.

Agents are still stealing funds, aiding fraud at the closing and looking the other way on questionable transactions. Current agents have relationships with the parties, while good in a business sense, these relationships invite compromise. On one recently reported incident, an agent documented a non-existent buyer's cash to close, permitted same day property flips, and failed to notify the lender when funds were accepted from and disbursed to third parties not identified as formally connected to the transaction.

The theft of funds and other frauds are serious problems, but are not the only way that unsupervised agents can cause havoc. Settlement agents can also act negligently, by failing to obtain the properly signed note, or to record the mortgage, thereby creating significant liability for lenders. Since settlement agents, including lawyers, are not uniformly required to carry liability insurance or fidelity bonds, lenders and consumers can have little faith they will recover their losses resulting from negligence or bad acts by settlement agents at closings.

In the past lenders have assumed the risk associated with the unregulated and unsupervised nature of the closing process because losses from fraud at the closing had historically been a small percentage of overall mortgage fraud damages. That is why most lenders focused whatever spending they could allocate to fraud deterrence on front end fraud detection software, such as social security number verification, automated appraisal reviews and similar products. According to the National Mortgage Bankers Association, lenders spent approximately $1 Billion on fraud deterrent software to use in the origination and underwriting process in 2011. The amount of money spent to address fraud and negligence at closing was not in the calculus.

The Inadequacies of the Closing Protection Letter

Other than faith in law enforcement, what can a lender do to reduce the risk of loss due to fraud or negligence at a closing? Each day when lenders wire millions of dollars into the trust accounts of attorneys and non-attorney settlements agents they have historically relied on the closing protection letter (in some states known as the insured closing letter) issued by title underwriters, through their agents, to seek recovery for their losses. These letters provide no relief when a settlement agent engages in intentional acts other than outrights theft of funds, or when an agent's negligence fails to rise to a non-curable cloud on title. The letter provides coverage for the lender against intervening liens. Fraudulently recording, cash to close on the HUD-1 with a straw buyer, and fraud for profit schemes are not covered incidents? As long as the insured can still foreclose, there is no coverage and no claim for lost interest or principal payments on the loan, cost to foreclosure, cost to repurchases (i.e. premium recapture), etc.

In the State of California, case law even supports the proposition that a closing agent has no legal or contractual obligation to report fraud at the closing even when the agent may personally witness suspicious or even fraudulent activity taking place(1) In 1999, in Voumas v. Fidelity National Title Co., the California Court of Appeals held that settlement agents have "no duty to police the affairs of a lender," and have no obligation to "report fraud." Similar results were reached in the

California decisions found in Axley v. Transational Title Ins. Co. and Lee v. Title Ins & Trust Co.

In reality a closing protection letter looks and smells like an insurance product, and today is charged to the borrower like it is insurance, but, in fact, is not insurance. Nor is the CPL assurance against mortgage fraud or theft at the closing table. Furthermore, there is no national standard for issuing closing protection letters. In most cases the lenders have had no real comfort in the existence of these letters as a method of evaluating the experience, trustworthiness, and reliability of the agents who will handle their funds and documents at a closing. Similarly, most lenders have had no standard policy for reviewing and verifying CPLs, not just for their validity (i.e. were they properly issues), but also to verify the credentials of this to whom the letters were issued.

Fannie Mae's Recommendations Were Ignored; Now CFPB Has Issued a Mandate

Fannie Mae's December 2005 Newsletter on "Preventing, Detecting & Reporting Mortgage Fraud" states in part that "mortgage lenders must know their business partners and consider using outside sources to selectivity choose closing attorneys and settlement agents." These guidelines mirror the guidelines issued by the OCC for supervised banks in 2001. Yet until April 2012 there were very few lenders that followed this sound advice.

In April 2012, the Consumer Financial Protection Bureau issued Bulletin 2012-3 which appears to mandate that non-bank entities, mortgage lenders and brokers, take affirmative steps to adopt adequate risk management policies to prevent consumer harm from third party service providers. This Bulletin reaffirms the existing requirements for supervised banks to non-bank entities that have been in place for years.

Today lenders, for the most part, have no comprehensive program to assess the risk from the actions of settlements agents. Compounding the problem, not one from the national or state bar associations, notary association, or title agents association have stepped forward with uniform standards, guidelines or requirements for certifying the qualifications of the people who control the loan documents and mortgage funds at closings nationwide.

Recently ALTA has published a new set of title agent "Best Practices," which is a welcome approach to publicizing uniform standards to a diverse industry. However even in the best of faith, with good intentions, voluntary industry associations have few resources to police their members, let alone turn them over to law enforcement and report them publicly for bad acts. Unfortunately, instead of embracing change in this area, some agents and small industry groups have decided to attack the messenger, or seek "exemptions" from compliance claiming that either "there is no problem," or that "we are regulated enough." Unfortunately the escrow and closing fraud loss figures don't support either position.

Without a new method of vetting, monitoring and evaluating the risk of settlement agents, and properly insuring them for both fraud and negligence at closing, it is foolhardy for lenders to continuing relying on the current closing protection letter as security for the proper coordination and execution of the mortgage loan closing process.

A Solution: Certification & Uniform Standards

The emerging solution is to supplement the vetting process currently used by the lenders and title underwriters with independent third parties to perform objective scrutiny and verification of the settlement agent's identity and credentials.

The Public Wants Change

In October 2012, an independent opinion poll was conducted by American Money Services of NY seeking public input on issues surrounding mortgage closings. The results were nothing less than fascinating, and should serve as a wakeup call for the settlement industry.

An overwhelming majority of respondents believe that only attorneys should be permitted to act as settlement agents. That the attorneys should be more carefully regulated, that providing for their independent certification based on criteria including experience, is essential to establishing public faith in the process. Furthermore, 79% indicated that they were unaware settlement agents are not all required to have E&O coverage when handling their real estate matters, 92% believe that settlement agents should meet minimum uniform standards or experience and skill besides being licensed, 93% believe that banks need programs to better identify people who may commit fraud in mortgage closing transactions, 97% believe banks need policies and procedures to ensure that whoever handles the closing funds and documents is trustworthy, 44% believe banks giving mortgage loans are doing enough to pro-

tect consumers from losses for fraud, while 56% say they are NOT doing enough. Interestingly, in contrast to public positions taken by some agent groups, 93% of the public polled in the survey stated that they would feel more comfortable at a closing with someone who had an independent, vetted designation. Finally, 70% of those polled believe that with improvements such as additional protections from fraud at closing, lenders can rebuild the public's trust in financial industry without government intervention.

After decades of allowing the title industry to regulate the risks at closing the lenders and faced with highly publicized plans for a Washington designed, driven and enforced consumer protection regulations, the banks have already moved toward initiating new safeguards and self-regulated programs. Why would the title industry not move forward on its own initiative and embrace these same safeguards?

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