THE ELIMINATION OF SALES FRAUD

By Martin Lavin

The Financial Services Division of MHI has recently identified sales fraud as a subject of paramount importance to its membership. The division has encouraged an open discussion of sales fraud, its causes and measures that could be taken by lenders to reduce its incidence and the severe losses it can cause.

To further this discussion, I decided to express some of my thoughts on the subject.

My background in manufactured housing began in 1972 as general counsel for a very large retailer which had about 100 sales locations at the height of the 1973-1974 boom period. I dealt with the various retail locations every day.

Since my employer controlled the rights to the physical locations, provided wholesale and retail financing, and shared in proceeds from each sale, we were very much involved in the retailer's business, both legally and financially.

From this background, and my involvement in manufactured housing lending since, I have been very concerned about eliminating sales and lending fraud for a very long time. In fact, you might say I tend to become emotional on the subject.

What is fraud?

In general, I would define fraud as some material misrepresentation on the face of the contract or the attendant information supplied by the applicant, retailer or other third party which, had the lender known the information, would have led to a different result, vis-à-vis the granting of credit.

Usually the fraud is meant to conceal facts that would have prevented approval of the loan, or the approval would not have been made as requested. Had the lender not approved the loan, presumably the misrepresentation or omission would have been without effect.

As lenders, we want to know every relevant detail about the transaction, the parties and the collateral. If material facts are concealed from us, we might well make a buying decision outside of our lending guidelines. It is these transactions—those not meeting the program guidelines—that experience has taught us have a much higher probability for losses, increasing to an unacceptable level very rapidly.

As Otto Wantuck's recent article on manufactured housing loans demonstrated, losses increase geometrically as credit quality diminishes. [See "The ABCs of MH Loans," in the February 1998 issue.]

The fraud is usually perpetrated to enhance credit quality. It doesn't take a large percentage of fraudulent loans to escalate losses quickly.

In the manufactured housing industry, lenders are happy if *only* 14 percent of the loans are defaulted over the life of the portfolio. So who needs to introduce more risk?

Since we are concerned primarily with sales fraud, we are discussing fraud perpetrated by the seller, which in our business is usually a retailer or one of his employees.

Unfortunately, this article may give the impression that this activity is carried out by all retailers. By no means is this the true picture. Most retailers are fine people and do not participate in fraud. Rather, the actions of a few unscrupulous people give rise to the concerns expressed here.

Let's look at the dynamics that have produced the industry's "wink and a nod" lending style that all of us so decry.

Typical loan applicants

It is no secret or shame that the average manufactured housing loan applicant tends to be in the "C" category—people with marginal credit who do not have as many alternatives in housing choices as they might like. While some of borrowers consider the purchase of lower-end site-built housing, more commonly the only other choice is a rental apartment.

Usually, the applicant is at a retailer's sales center when the application for credit is sent to a lender. Many applicants who successfully obtain loans have only marginal credit. So it's only human nature that a loan applicant often fails to disclose his true situation in one or more material ways, especially if it looks like a candid portrayal will lead to a denial.

Hoping for a sale, the salesperson also tends to "dress up" the application to improve the chances for an approval.

Mostly, that lack of candor revolves around the equity the borrower is bringing to the transaction—in other words, the down payment. Let's all be candid. Lenders give plenty of lip service to the down payment, but they are often less concerned about its reality than in using the stated amount as a trigger to determine the interest rate, the length of term and other loan parameters.

A marginal borrower, who needs "help" qualifying, often tacitly or expressly conspires with the seller (usually the retailer) to put on a charade to mislead the lender. The down payment, or one or more of other loan factors, is sometimes inflated through a misrepresentation. Thus, lenders buy a loan that has a different basis than they believe.

Thank our stars that every fraudulent transaction doesn't result in a default and subsequent loss. Fraud per se, even when it is material, is not a sure precursor of default leading to loss. Certainly, this is one of the key reasons why fraud is uneasily accepted in our lending. All of us know a certain amount of fraud exists in the marketplace, but only in cases of extreme loss do we do much about it.

While fraudulent loans are not certain to lead to default, they do lead to a much greater incidence of default. So lenders fear this type of activity, especially when it goes beyond the usual amount they are willing to tolerate.

Many times. the borrower participates with the retailer in the misrep-

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resentation. He views the offending retailer as an industry representative, and often believes that the fraud is only a means to an end. It's OK because the retailer told him this is how it is done to get that home he wants. In other cases, the borrower is not entirely sure what is occurring.

In my experience, however, the borrower will usually tell the truth about a transaction if you ask him, especially before the closing. You have to ask him, though.

Two categories of fraud

Fraud comes in more forms than I can enumerate. New forms keep cropping up so routinely that I'm awed by people's ingenuity. But in general, they break down into two broad categories.

The first I regard as "soft" fraud, that is, a material misrepresentation which tends to "dress up" the transaction without materially misrepresenting the two most important factors: the applicant's demonstrated desire and ability to pay and the true collateral.

These misrepresentations may involve the down payment, time on the job and many other factors. While it would be much better for the lender to know the true state of affairs, an astonishing number of these soft fraud transactions occur. They are part of the "wink and a nod" attitude that the industry has frankly accepted and for which it makes provision in its loss calculations.

The second form of fraud is more to be feared: the so-called "hard" fraud. This involves material misrepresentation of an extreme form, in which both the applicant and the collateral are grossly misrepresented. It denies the lender any real ability to underwrite the loan. The whole transaction is fraudulent and conjured up by the retailer, who provides a working capital loan or a cash advance for whatever reason.

This form of fraud almost always leads to losses—sometimes very large ones. Often, the defrauder has every intent early on to repay the loan. However, if the first instance of hard fraud goes uncorrected, it often leads to multiple occurrences to keep up appearances. It is not unusual for cases of this type to have dozens of transactions funded that are the worst sort of hard fraud.

At that point, the lender has a problem of significant magnitude. Unraveling it will cost lots of hard work, frustration and money. Lender employees often lose their jobs over this activity.

The four horsemen

These are the types of transactions I was involved in to a great degree during the incredible upheaval of the mid-1970s. Retailers were scrambling to maintain their businesses in the face of losses resulting from four factors:

• The chargeback of unearned finance and insurance income.

• The call by lenders to repurchase fraudulent and/or repossessed transactions.

• The increase in inventory carrying costs.

• The decrease in sales volume and margins.

If that doesn't remind you of the Four Horsemen of the Apocalypse, I don't know what does!

Could those conditions return again? You bet they can. The increase in the "hard" fraud cases that have been visited on lenders in the past year is unlikely to subside—unless you really believe that interest rates are unlikely to ever increase, that the business cycle is abrogated or that most retailers are so well capitalized that the return of the Four Horsemen won't undo them.

The reality is that manufactured home retailing, though highly competitive, is a relatively easy form of business to start. Virtually anyone with selling experience in the industry can launch his own sales location. Generally, he has formed a rapport with one or more finance company people, and has probably impressed them with his abilities.

The finance company account manager is under the pressure of quotas to originate loans for new sales locations. His belief in the applicant will go a long way towards convincing the credit underwriter that either wholesale or retail financing, or both, should be granted, even though the applicant is thinly capitalized.

So the lender issues a traditional "character" loan and puts the applicant in business, in many cases neglecting to properly underwrite the transaction. The lender simply believes in the new retailer applicant and hopes he will succeed.

Over time, new retailers carry a very large potential for getting into financial trouble. They are generally very thinly capitalized, and during these early years their resources may be unable to contend with sales slumps, off-seasons, competition and other disruptions that afflict every new venture.

Yet, lenders have competitive pressures that compel them to finance these folks, because many of them eventually become established retailers and are very profitable for us. If we don't finance them, there always seems to be someone who will. Our failure to step forward makes us seem overly cautious.

By no means does every retailer who fails in this business leave his lender with large losses, nor does every thinly-capitalized retailer fail.

Every time a new retailer opens for business, there is a secondary effect on the marketplace. Invariably, he brings new competition that potentially weakens established retailers, due to the resulting decrease in margins and sales volume.

This may not happen in a strongly expanding market such as we've had in the mid-1990s. But the increase in retailers after 1995 and the subdued growth in volume in 1997 and 1998, have cut into the volume and profit pie to some degree.

If volume decreases at anywhere near the rate it did during several periods since that banner year, 1973, when more than 550,000 homes were delivered, the increased incidence of fraud, a byproduct of every downturn in volume, will be with us again. The resulting dislocations may not be as bad as during other downturns, but they will still be ugly.

What can be done

Now that we've outlined the conditions that lead to fraudulent transactions and some of the forms they take, it's time to talk about what we can do as lenders to protect ourselves from the very worst of them.

We are in a very fast-paced business. An application processed today from a prospective customer could put the buyer in a home tomorrow. Can you conceive of a real estate loan closing in that manner? Of course not. A real estate loan would be considered fast if it occurred in 30 days, and 60 days is not considered an unusually long wait.

What is the difference? Paperwork, lawyers, disclosures, proof of down payment, sources of funds, title companies, appraisers and appraisals, and a flock of other factors are potentially involved in secured lending for real estate. Invariably, a whole series of checks and audits occur before

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closing.

This whole system is formalized, with ample opportunity to ferret out all of the relevant facts. Misrepresentation depends on several parties' conspiring together, some of whom have little or no incentive to participate in the misrepresentation.

This deliberate and exhaustive procedure is common in real estate closings, and therefore is expected by borrowers. This process tends to keep real estate transactions less burdened by fraud.

Does this mean all real estate deals are clean? No. Does this mean the manufactured housing industry should adopt this slow, highly formalized, third-party intensive process? Again, no. But there are some lessons to be learned which we might well adopt to protect ourselves as lenders to a much greater degree.

Former President Ronald Reagan said it best: "Trust, but verify." Lenders who are really serious about preventing sales fraud should audit to some degree. Auditing every transaction may too cumbersome, but some should be. Not only that, but the audit should be done before the loan closes. It's shocking how many lenders fail to audit entirely, or do so only occasionally or poorly.

Retailers object very strongly to auditing transactions before their close. Some lenders audit some or all transactions after they close. But the after-closing audit, as one lender recently found out in the Northeast, can lose an account.

The retailer refused to honor his commitment to purchase the loans back. Instead, he went to the competition for future financing and procured it. The lender had to resort to very expensive and ugly legal action to try to get his money back. Obviously auditing beforehand would have been a better course.

This type of situation is so prevalent that there isn't a lender who hasn't encountered it, if he's been in the business more that three months.

The heart of the matter is to safely audit enough transactions to keep fraud to a minimum, without angering the retailer or customer and decreasing volume.

How do lenders protect themselves from taking on a retailer who has defrauded a previous lender? Conversely, how do we alert another lender of fraudulent activity by a retailer towards us?

You could either aggressively audit all transactions, and assume the risk of diminished volume, or you could audit only a few, and reserve highly for losses.

Obviously, either course has limitations. Aggressive audits make you seem inflexible. They are also difficult to do well, and certainly could lead to a decrease in volume. Yet too many lenders today are not doing much auditing before or after the loan closes. The very cautious lender will find little role for him in the marketplace under present conditions.

On the other hand, if you do little or no auditing, especially before the transaction, by the time you know you have problems, the scope is likely to be very large. Reserving enough money to cover these heavy defaults will make your loan prices non-competitive.

I remember a retailer in 1988 for whom we financed 41 homes, of which 39 were repossessed. All of them involved fraudulent transactions. Interestingly this retailer has been in business without a break for more than 20 years. He has always had financing and, to my knowledge, continuing problems with lenders. Yet he goes on.

Biting the bullet

In order to survive in this business over the long haul, we must do some things that will be difficult in the short term. They may diminish volume, and perhaps lead to less profits during banner years.

The temptation is great to do otherwise. But here are some things we should do consistently to reduce the incidence of sales fraud and the resulting losses. Consistently done, they will cost you some business during the go-go years, but they'll save you much anguish during downturns:

- ***Audit a portion of your loans before they close and some after they close.*** The buyer will tell you the truth about the deal most of the time, especially if you talk to him before the transaction closes.
- ***Audit loans from new dealers more frequently, but audit everyone.*** Anyone who maintains that his loans shouldn't be audited should be audited immediately. Start and perpetuate the thinking in the business that the lender has the right to know all the facts of the transaction, and insist on it.
- ***Reserve amply for losses caused by fraud or other reasons.*** Not all our defaults are caused by fraud and not every fraudulent deal defaults. Know as a lender that this is the arena you are playing in, and you are not going to change it alone.
- ***Accept that many "soft" fraud deals will happen, and that some are a natural part of your volume.***
- ***Audit for "hard" fraud loans.*** These will default with spectacular and costly regularity. They are the type that take the guts out of an organization and have caused many to flee the lending business in the past. Do not be timid about this and do not condone it. Remember the old manufactured housing maxim: "Your first loss is your least loss."
- ***Once you find hard fraud, cut your ties, take whatever steps you can to recoup any losses and make sure that, to the legal extent you can, you alert other lenders about your experience with this party.*** This individual should have no role in our industry.
- ***Remember that thinly-capitalized retailers have virtually no ability to stand behind their recourse and buy back obligations.*** Do not make any loan with the belief that you'll over-

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look false information, or fail to uncover false information because you are depending on the recourse commitment made by the retailer to be your protector. Buy loans as though every one of them is non-recourse.

• *Realize that your sales representative can become friendly with retailers and it is human nature to overlook some things that perhaps he sees but doesn't report.* Establish daily internal and underwriting concerns about hard fraud. Teach the danger signals. Counsel your people that their integrity and career may hang on this.

• *Check on your retailers occasionally to see how they are doing with the other lenders they are using.* Perhaps they just haven't gotten to you yet, but they may be already in trouble with some of the others. Be prepared to discontinue the relationship or, at the very least, step up your pre-closing audits.

• *Be suspicious of anyone in the business who calls and says they have no financing at present and are anxious to get your program.* How could they have been in this business during the last few years and not have dealings with one or more lenders available in the marketplace? This type of call should tip you off that something may be amiss.

• *Create an awareness of high-mindedness and ethical dealings in your organization.* Let your people know you'll pass up volume in order to safeguard the integrity of your loans. Let them know that there are limits beyond which you will not go, and that, once burned, you don't go back for seconds.

• *Lastly, understand and accept that defaults and repossessions, fraudulent or not, are a part of our business.* My experience tells me that, one fine day in the future, a heavy string of defaults will occur as some economic upheaval forces many of our borrowers into insolvency, so that they will be unable to continue to service their debt.

When this happens, the defaults will be very heavy for six to 18 months. It will try your patience to hang in there. In the past, such defaults have sent lenders scurrying to flee the business.

Aside from some of our present lenders who successfully survived the downturn in the mid-'80s in Texas and early '90s in the Northeast, how many lenders have been lending continuously on manufactured housing over the last 25 years? Not too many.

Defaults, coming in bunches like they tend to do, overwhelmed many in the past. It seemed that lending on this product would never again be profitable. Quite the contrary, lending has always returned to profitability after a time.

Those that used the downturn as an opportunity to review their policies and procedures, reexamine their operating styles and tighten up on their lending and service aggressively and intelligently, not only survived but prospered in downturns. I am aware that it will take steel nerves to persevere if defaults rise dramatically in the future, but it has paid off in the past and will again.

Will my recommendations bear any fruit? Not unless the large lenders active today decide that fraud, especially hard fraud, will not be tolerated.

This will only work if the lenders view parties violating their trust as people to be avoided instead of an opportunity to pick up a new account. It will not work if the only time fraud concerns us is after the fact, when we are looking at one or more repossessions caused by retailers who grossly misrepresented their transactions.

Too often, my experience has been that the lenders react like the corrupt French police captain portrayed by Claude Rains in the movie *Casablanca*, who is ordered by his German overlord to shut down Rick's Café Americain, but he must find a pretext. "I'm shocked, shocked to find gambling going on here," he exclaims, just before he is handed his winnings. All the time he knows, but chooses not to notice.

Too often, our lending is carried on in this "wink and a nod" fashion. We can do better. ■

Martin Lavin is a consultant for Mortgage Services Inc. (MSI), a consumer finance lender based in Burlington, Vt. He has been active in the industry as an attorney for retailers, manufacturers, developers and community owners since 1972.

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