

# Mortgage Fraud

Recession and recrimination: A guide to mortgage fraud



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## 1. INTRODUCTION

This guide is not about case law or statute. The charges which commonly arise in mortgage fraud cases (Fraud by False Representation, Conspiracy to Defraud, False Accounting and Fraudulent Trading) are well known to practitioners. This guide is an introduction to some of the practical issues that arise in dealing with mortgage fraud cases: the common types of fraud that may arise; the issues that affect the different professionals who may come under investigation; and some of the areas that may be relevant in defending a claim.

History tells us that the UK property market is cyclical. Boom and bust has been the pattern. In a rising market, some participants become greedy; many become sloppy; even more convince themselves that prices will just keep rising. It is when the market starts to crash that recklessness, negligence and fraud are exposed.

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Estimates by the UK mortgage industry are that the loss is approximately £1 billion per annum - roughly equivalent to the annual loss from benefit fraud and representing about 0.7 per cent of mortgage lending. However, that leaves out of account the 'no loss' mortgage frauds.

## Understanding the pressures of the market

In any mortgage fraud case, there will be a focus on the issue of dishonesty. Consider whether discrepancies in paperwork may be explained by pressures of work or by lax working practices, and place it in the context of the industry.

Hundreds of thousands of UK jobs are dependent upon the mortgage industry, whether brokers or bankers, surveyors or solicitors. Like all sectors of financial services, there has been a tendency to focus on short-term returns. There is pressure simply to complete the deal. For most participants in the industry, there is no money to be made from turning loans down. Commissions, bonuses, sales targets and the threat of competition means that at all levels there is pressure on individuals to push deals through with little regard to the risk.

## 2. MATERIALITY

Materiality can be an important issue in a mortgage fraud trial. The prosecution may argue that all representations are material. Mortgage application forms will generally contain a declaration to the effect: "All information contained in this form is true, accurate and complete". However, not all representations are critical to a lending decision and in a case where dishonesty is in issue, it may be relevant to focus on the importance of the representation. An understanding of the basic concepts of materiality is therefore important.

In deciding whether or not to lend money on a property purchase, the lender will consider three issues:

- The value of the security
- The value of the borrower's covenant
- The deposit

### Value of the security

This is essentially the value of the property which is the security of the loan. It is the asset that the lender will rely upon to repay the loan in the event of default. The lender will generally instruct an independent

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valuer to provide a report on open market value. The loan-to-value (LTV) ratio is critical to the lending decision: the higher the LTV ratio, the more risky the loan will be.

## **Value of the borrower's covenant**

This is the ability of the applicant to service and repay the loan. There is a critical difference between domestic and buy-to-let mortgages.

In a domestic (owner-occupier) mortgage, the applicant will repay out of their own income. A critical issue in the lending decision is therefore income and creditworthiness. The personal financial information set out in the application form (salary, length of employment, savings) will be critical to the lending decision.

In buy-to-let mortgages, the applicant will repay from the rental income. The critical issue is the expected rental income. That is generally a valuation issue. Mortgage application forms will still require the applicant to set out details of their employment and income. However, lenders have conceded that this is often disregarded in the lending decision. This may be explicit in the published Lending Policy of the individual lender. It may also be explicit in the notes of the underwriter. It may simply have to be confirmed on a case-by-case basis through enquiries.

Ensure that the prosecution to produce (a) the Lending Policy that was in force at the time the loan was granted and (b) the working notes of the underwriter who approved the loan. In respect of each alleged misrepresentation, consider whether it was truly material to the lending decision.

## **The deposit**

The existence of a deposit and (in some cases) its source will be material to the lending decision.

The existence of the deposit is relevant to the value of the security. It is the cushion between market value and the amount of the loan, protecting the lender against shortfall either from costs of sale or a fall in value. For reasons set out below, this is an important issue for solicitor defendants.

In most domestic mortgages, the source of the deposit is also relevant to the value of the borrower's covenant. The deposit is regarded as proof that the borrower is not a man of straw. In such cases, lenders will expect confirmation that the deposit has come from the borrower's own resources, as opposed to a gift or a loan. That is not necessarily the case in a buy-to-let mortgage.

## **Fraud Act 2006**

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The Fraud Act 2006 made a fundamental change to the law of fraud in the UK. Under the Theft Act it was necessary to prove actual deception. Under Section 2 of the Fraud Act 2006, the prosecution no longer have to prove that anyone was deceived by a false representation.

Under Section 2 of the Act, the elements of the offence of fraud by false representation are:

- (a) the defendant makes a representation which is untrue or misleading;
- (b) the defendant knows that it is, or might be, untrue or misleading;
- (c) the defendant is thereby acting dishonestly; and
- (d) the defendant intends to make a gain for himself, or to cause loss to another.

An astute prosecutor may try to sidestep the issue of materiality, or even complicity/acquiescence on the part of bank employees, by relying upon this. However, a materiality argument is still a viable line of defence as it remains an aspect of dishonesty, even if no longer a separate element of the offence.

### 3. PARTICIPANTS IN THE MORTGAGE PROCESS

There are many players in the mortgage process - some of them often unseen. Consideration has to be given to the role each plays, and whether they may be implicated in a fraud.

#### **The Buyer**

The buyer is the person who applies for the mortgage and receives the advance. However, it would be wrong to think that the buyer must be the person who lies behind a fraudulent mortgage application. Many fraudulent schemes involve the use of "mortgage mules" - ordinary people who may be put up to making an application by more sophisticated criminals. As with drug mules, the question is whether they were in on the scam. Also, in more straightforward cases an innocent buyer may be the unwitting victim of a broker who massaged their application to ensure that it gets approval and he gets his commission.

#### **The Seller**

Sellers will often be innocent players (if not victims) in a mortgage fraud (eg. identity fraud, false income details). However, a valuation fraud is likely at some point to involve a complicit seller. Unless there has been deception over the transfer price, the full purchase price is remitted to the seller, so on the face of it the beneficiary of an overvaluation is the seller, not the buyer. This is often achieved by sub-sale fraud (see below). Developers are also commonly implicated in frauds (eg. cash back arrangements to conceal the

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lack of deposit). Dishonest sellers may sometimes recruit a 'mortgage mule' as a buyer in order to offload a property at an inflated value.

## **The Broker(s)**

A broker assists the applicant to find an appropriate lender, to complete the application and to collate supporting documents. Suspicion will often fall on a broker because of their expertise and their central role. Because they are mostly commission-based they are often accused of putting the best possible spin on the applicant's case.

## **The Packager**

Packagers stand between the applicant/broker and the lender. They have a marketing role in promoting the lender's products. They also have a role in processing applications, in that they will collate the information, carry out credit checks and deal with any queries. They may give the instructions to the valuer. They then present the application to the underwriter as a ready-made package.

## **The Underwriter**

The underwriter will generally be a direct employee of the lender. It is his/her decision whether or not to approve the application and, if so, on what conditions.

## **The Employer or Accountant**

In mortgage fraud cases based on false representations as to income, it is often alleged that an employer or accountant was complicit. There may be active deception, in the form of false wage slips, references or accounts. Self-certified mortgages generally avoid the need for such false information, but forms will still require the employer or accountant to be named, and the issue is likely to be complicity. Did the applicant simply gamble on the fact that no-one would check, or was the employer/accountant in on it?

## **The Valuer**

The valuer reports to the lender. However, the valuer may have an established relationship with a broker or even with the buyer. The role of the valuer is considered below.

## **The Solicitor for the buyer/lender**

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In the overwhelming majority of cases, the same solicitor will act for the buyer and the lender. Again the role of the solicitor is considered in detail below.

## **The Solicitor for the seller**

The solicitor for the seller has no involvement with the mortgage application itself. In most cases, it will be difficult to prove complicity on the part of the seller's solicitor.

## **4. TYPES OF MORTGAGE FRAUD**

Mortgage frauds essentially fall into two groups: cases where the objective is to acquire property using fraudulent finance; and cases where the objective is to obtain the cash advance and disappear with the money.

There is no limit to the types and variety of mortgage fraud, but the following are common:

- False information about income / savings
- False identity, including false firms of solicitors
- Overvaluation fraud
- Non-existent deposits, often linked to overvaluation fraud
- Sub-sale (or back-to-back) frauds ('Mortgage flipping')
- Use of 'mortgage mules' as proxies for organised criminals.
- Use of property purchases as a means of laundering the proceeds of crime.

Sub-sale fraud requires some elaboration. How can an overvaluation fraud benefit a dishonest buyer? Generally, it is the seller who benefits.

A common device is a dishonest scheme in which a property is bought and sold on. A (innocent seller) sells to B (crook) who then sells on to C (usually a 'mule') at an inflated price. This sub-sale may take place on the same day, or some months later (often more than 6 months later, to comply with reporting requirements). The dishonest profit is made when B sells to C. C may then disappear or otherwise default.

Allegations of sub-sale fraud need to be carefully examined. There is nothing illegal in flipping properties per se. Lots of businesses sell on for a quick profit. The explanation may be that A sold below market value (eg. an auction sale) and B was able to turn a quick profit. There may have been improvements to the

property or the surrounding area. The market may be rising. Sub-sales may give rise to suspicions, but in the absence of clear evidence of overvaluation, it is unlikely that fraud will be established.

### 5. PARATUS AND THE CONDUCT OF THE LENDERS

The conduct of the lenders has come under scrutiny in some cases. Through the boom years of the 2000s they were justifiably criticised for reckless lending policies. In Paratus AMC Limited/ RMAC plc v Countrywide Surveyors Ltd (2011) EWHC 3307, this was considered in the context of a High Court claim against a valuer. The Court considered evidence about the application of lending policies by GMAC underwriters and found that basic enquiries had not been made (eg. a credit check had disclosed substantial credit card debts which had not been disclosed). The Paratus judgment is useful evidence of how all participants, including the banks themselves, made mistakes under the exceptional pressures of the mid-2000s market.

Beware the use of aggressive tactics by lenders. Civil claims framed in negligence / breach of contract can be met with a counter-allegation of contributory negligence. However, a rule known as the SAAMCO principle holds that contributory negligence is no defence to a claim which is pleaded in fraud (see South Australia Asset Management Co v York Montagu Ltd (1996) 3 All ER 365). There is therefore a huge incentive for lenders to allege fraud in cases which would previously have been dealt in a more straightforward fashion. Operation Valgus is a case in point. The investigation was initiated by solicitors acting for Bradford & Bingley (Mortgage Express), who subsidised the early stages of the investigation and provided legal support to the police.

### 6. ISSUES ARISING WHEN ACTING FOR THE BUYER

A superficial view of mortgage fraud is that the buyer is the person at the heart of the process: they make the application; they get the advance; if there has been a misrepresentation surely they must be involved.

The reality is, of course, very different. In organised frauds, buyers may well be 'mortgage mules' who were recruited because of their financial naivety, placing their trust in a friend, broker or adviser. Consider

whether the evidence shows that they completed the forms themselves, or simply signed on the dotted line where they were told. Was the form complete when they signed it? Were all the pages present?

Consider whether false information was provided further down the line. Brokers, packagers and even underwriters are under pressure to approve loans. Have they altered an application as it passed through their hands to make it conform to the lending policy?

## 7. ISSUES WHEN ACTING FOR VALUERS

The primary evidence as to the value of the security will be an independent valuation report prepared by a chartered surveyor on behalf of the lender. The surveyor is instructed by the lender (not the buyer) and is paid a fixed fee regardless of whether or not the loan is approved. So what could go wrong?

### Conflicts of Interest

Although notionally independent, the reality is that surveyors are likely to be working in a limited market where they know the other personalities involved in the property world (eg. estate agents, developers, brokers, even buy-to-let investors). It is not difficult for a broker to manipulate an application to ensure that the lenders' instructions go to a 'tame' valuer. There are cases of blatant corruption - backhanders. There is also more subtle corruption - a valuer may be dependent on an individual broker or developer for a significant proportion of their income; they do not want to get a reputation for being difficult by valuing properties at less than the agreed price.

Consider what evidence there is of a connection, either direct payment or repeat instructions.

Acting for a client where there is a conflict of interest is likely to be taken as evidence of dishonesty. Under the Protocols published by the RICS, there are specific definitions of conflict of interest which have to be borne in mind. These include the following:

- Acting for two clients in the same transaction
- Valuing a property previously valued for another client
- Valuing for the lender when previously gave a valuation to the client



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- Receipt of financial incentives.

The existence of a conflict of interest is not a bar to acting, but the duty of the surveyor is to report it to the client.

## Core Documents

The regulatory documents which should be considered are as follows:

- RICS Rules of Conduct. Like the Code of Conduct for Solicitors, this was formerly a detailed and prescriptive set of rules. The revised code is a statement of core principles which runs to a single side of A4
- The 'Red Book'. (Officially, the Practice Statement on Valuation Standards). This is the definitive guide as to what is expected of a surveyor carrying out a valuation. It is a voluminous publication which sets out technical requirements as well as ethical standards
- RICS Protocols and Practice Statements

Consider also the pro-forma valuation reports which are provided by the lenders. Mortgage valuation reports are not bespoke reports containing a detailed description. They are computer-generated documents that are completed using electronic templates or software. It is a tick-box exercise. In some cases, no opportunity arises to add comments or qualifications to the basic information.

## Retrospective Valuations

Any prosecution of a valuer is likely to consider expert evidence of retrospective valuation by an independent valuer. As is well known, there is a threshold of about 10% which is deemed an acceptable margin of disagreement. Surveyors will endlessly debate whether their role is an art or a science. The reality is that their valuation figure is a judgment based on the evidence of an inspection, a review of comparable prices and their own knowledge of market conditions.

The following issues should be considered:

- Expert evidence for the defence should always be sought
- Comparables are the key to valuation evidence. What comparables did the retrospective valuer consider? Are they a fair comparison? Were these comparables available to the defendant at the

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time of the original valuation? Are they in the public domain? Do they post-date the original valuation?

- Is the retrospective valuation by someone who was working in the local market at the time? The red book suggests that a surveyor should only report on properties within 25 miles of their office base.
- Is there an innocent explanation for the difference in value? For example, is there an error of measurement?

## **The importance of the purchase price**

Perhaps contrary to expectations, a surveyor is entitled to (and should) take into account the price which has been agreed between the buyer and seller. Although the report to the lender is on the independent value in the open market, the actual sale price which has been agreed is important evidence of what the property is worth. It should not be regarded as suspicious that the valuation figure matches the sale price: that is perfectly normal in most transactions.

## **The importance of the climate**

In reviewing the work of a surveyor, it is important to understand the climate they were working in at the time. Many cases which are still working their way through the system involve surveys conducted in the mid-2000s. This was a difficult time in that a booming property market created huge volumes of work whilst structural changes meant that many surveyors were being placed under huge pressure of work by their employers.

By the mid-2000s, the market for mortgage valuation reports was dominated by a handful of national companies that had contracts with the lending institutions. Individual surveyors - many of whom previously ran their own, local practice - were forced to work for such companies at comparatively modest rates of pay. They were set demanding targets for the number of reports they had to turn around each day. Cases can be explained as neglect and overwork rather than dishonesty.

## **8. ISSUES ARISING WHEN ACTING FOR SOLICITORS**

The following materials need to be considered when acting for a solicitor defendant:

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- The Solicitors' Practice Rules 1990 / Solicitors' Code of Conduct 2007 / SRA Code of Conduct 2011. These are particularly important in defining the scope of the solicitor's duty when acting for both buyer and lender.
- The Solicitors Accounts Rules 1998 / SRA Accounts Rules 2011
- The Guide to the Professional Conduct of Solicitors. This sets out regulatory requirements with guidance and commentary.
- The CML Lenders Handbook, issued by the Council for Mortgage Lenders. Compliance with the Handbook will be a term of the solicitors' retainer. In particular, it obliges the solicitor to report any discrepancies in relation to the payment of the purchase price.
- Standard Certificate of Title and Disclosure of Incentives Form. These are the two central documents that the Solicitor will submit to the lender in order to trigger the release of the mortgage loan. The important fact sometimes overlooked is that by signing the form, the solicitor is certifying compliance with all the requirements set out in the CML Handbook. The Disclosure of Incentives Form has been in place since September 2008 and places an explicit duty to report anything which might amount to a hidden discount on the purchase price.
- The Property Fraud Warning Card (the 'Green Card'). This was introduced by the Law Society as a brief reminder to solicitors of the warning signs which they should look out for when instructed in a mortgage transaction. When breached, it can be relied upon as evidence that the solicitor has acted fraudulently. It concludes with the warning: "Any failure to observe the signs and to take the appropriate steps may be used in court as evidence against you if you and your client are prosecuted, or if you are sued for negligence".
- The Money Laundering Warning Card (the 'Blue Card'). This serves the same purpose as the Green Card in respect of warning signs of money laundering.
- Special Conditions. The first document that a solicitor will receive from the lender is a letter of instruction enclosing a copy of the Offer of Mortgage. In many cases, they will be in standard form. However, care should be taken to identify special conditions that may be introduced where the underwriter has concerns about a mortgage (eg. as to the source of the deposit).

As with all aspects of the property market, the Handbook, Rules etc have changed many times over the years and it is important to check that any such document was current at the time of the transaction under investigation.

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In most cases, the same solicitor will act for the buyer and the lender. Prosecutors have been known to suggest that where mortgage fraud has taken place, the solicitor must have been complicit, and that is the suggestion in the Green Card. However, the first issue is to identify where the fraud lies. A proper analysis of the conveyancing transaction shows that the solicitor's role is confined to particular aspects. In particular:

- The solicitor is not expected to check application forms. In most cases they will never even see the forms: they are first instructed by the lender at the time the Offer of Mortgage is made. By that stage, the packager / lender has already made all relevant credit checks to confirm the status of the borrower.
- The lender is not expected to challenge the valuation. (see Section 4 of the CML Lenders Handbook). Again, by the time the solicitor is instructed for the lender, the valuation will already have been seen and approved. There is a duty to check assumptions as to title and to report any obvious discrepancies, but there is no duty to check the accuracy of the valuation.
- The solicitor is not obliged to meet with the client personally and may take alternative steps to verify identity. This is increasingly the case with the use of 'conveyancing factories'.

## Use of the Green Card

The prosecution will almost certainly rely upon the provisions of the Green Card as evidence of complicity. The first part sets out signs to watch for, including:

- Fraudulent buyers and fictitious solicitors
- Unusual instructions (eg. remitting proceeds of sale to a third party)
- Client selling at a substantial profit for which there is no explanation
- Deposits paid direct to the seller

The matters set out in the Green Card are considered to be warning signs of fraud, but it should be appreciated that their presence is not per se evidence of fraud. The second part of the card makes this clear. The duty of the solicitor confronted with such signs is to make enquiries. There may be a ready explanation. The solicitor will be expected to show what steps he/she took to satisfy him/herself that it was safe to proceed.

## Deposits, the Duty to Report and the Certificate of Title

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As noted above, the Certificate of Title (CoT) is a core document. By signing the CoT, the solicitor is on the face of it verifying that they have complied with their obligations under the CML Handbook. If a solicitor is complicit, it is almost invariably by signing the CoT that they actively participate in the fraud.

In practice, some solicitors may not think through the full implications of signing the CoT. It is sometimes viewed as a mere formality - a means of triggering the release of the mortgage advance. In practice, there is some flexibility of interpretation. For example, the CoT contains a statement as to the "Date of Completion", which tells the lender when to release the funds. In practice, many solicitors put down a date one or two days in advance to ensure that funds arrive in time. Also, sub-sales are not always reported, even though the CML Handbook states that they should be. Guidance should be sought from an independent conveyancing expert.

Strict compliance can also rebound the other way. In R v Cornelius (2012) EWCA 500, the solicitor had submitted a certificate of title that was literally correct, but he did not disclose a prior transaction that fell outside the precise requirements of what he had to disclose. The prosecution argued for a broad interpretation of the solicitor's duty and said that the omission was dishonest. The Court of Appeal quashed the conviction. Certificates of title and the CML Handbook should be construed strictly in the defendant's favour. If the CML wished to impose a more onerous responsibility on solicitors, they should ensure that the form of the Certificate of Title made their precise requirements clear.

It is in the manipulation of deposits that the solicitor is most likely to be implicated. In a valuation fraud, the solicitor is not under a duty to question the valuation, but may well be involved in the manipulation of deposits as a consequence (eg. the overvaluation may be compensated by an undisclosed discount). The solicitor's ledgers, accounts and completion statements will be reviewed. They are not documents that they are obliged to submit to the lender, but they may provide evidence that the solicitor knew that the representations in the CoT was untrue.

Likewise, in cases where a buyer has lied about their financial circumstances, there may be an issue about the source of the deposit (eg. 'mortgage mule' cases). Special Conditions in a mortgage offer may require a Solicitor to verify the source of deposit.

## 9. CONFISCATION AND MORTGAGE FRAUD

With regard to mortgage fraud, confiscation is not:

- Complicated

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- A fine or additional punishment for the indicted offence
- Compensation or restitution
- The amount personally pocketed

Rather, when looked at in the context of mortgage fraud, confiscation is recovery of the amount obtained from criminal conduct by an individual or group of individuals convicted on an indictable offence.

The Supreme Court has not changed the law of confiscation in any way, but has merely directed Judges how to apply the current regime in a manner compatible with the European Court of Human Rights. The Proceeds of Crime Act (POCA) paid scant regard to the same. The Supreme Court has not created a judicial discretion and made it clear that only Parliament could create this. Any deprivation of property must be proportionate to the legitimate aim of POCA, which is to remove from criminals the proceeds of crime. The punitive and deterrent elements are obvious, but secondary. If a defendant has fully restored the proceeds of crime, it would plainly be inappropriate and disproportionate to make a confiscation order, as to do so would not satisfy the statutory purpose of POCA and would simply be an additional penalty.

## 10. CONCLUSION

Where mortgage fraud occurs, it is easy for the prosecution to put all the defendants together and suggest that they must all have been in it together. Defending such cases involves a careful analysis of the respective roles of the different participants, the scope of their professional duties and the pressures they were working under. Very often, fraudsters will deliberately choose to use innocent participants as a cover for their fraudulent activity. The issue of dishonesty is a simple one for a jury to grasp, but careful analysis is required to demonstrate how the transactions appeared from each defendant's differing perspective.