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Warehouse Lending and the Financial Institution Bond.

Financial Institution losses due to Warehouse Lending Fraud have increased significantly in recent years. But such losses are rarely, if ever, covered under the bank's Financial Institution Bond.

Warehouse lending refers to a short-term line of credit extended by a bank to a mortgage lender (or broker), who uses the revolving line to fund home mortgage loans. Those loans are typically packaged later and sold to investors in the secondary market. The whole process, including repayment to the originating bank, is completed in a matter of thirty or sixty days, and that short time frame makes "warehouse" an apt description for this kind of lending.

The funding of warehouse loans can be *Wet* or *Dry*:

When the bank makes the loan funds available before the closing, **AND** before the bank has received the loan documents, including the promissory note, that are its collateral, then the funding is called **Wet Funding**—the money is there before the ink on the documents has had time to dry, so to speak.

What is Dry Funding?

Dry Funding is where the promissory note and mortgage are signed and delivered to the bank before the closing of the underlying purchase—only then are the loan funds released.

Dry funding is obviously the more conservative and safer approach. With the loan documents in hand, the bank has some assurance that the underlying transaction, principals, and security, really exist. Moreover, the bank has the opportunity to perform appropriate due diligence of the borrower.

The Unique Perils of Warehouse Lending

But whether the funding is wet or dry, warehouse lending subjects the bank to perils not typically associated with traditional lending. By its nature, warehouse lending thrives on volume and frequency. As to both, the higher the better.

Moreover, the warehouse lender knows that the borrower will not be its long-term customer. Thirty, sixty, or ninety days after the bank pays out its loan funds, it is repaid. In short, warehouse lending often does not include the exacting scrutiny and underwriting that more traditional lending does.

Because of these factors—quick turnover and limited due diligence—dishonest mortgage lenders can and will find openings in the system for fraud. There are many variants, but typically the mortgage lender, sometimes in collusion with a closing agent or straw borrower, will submit forged or otherwise phony loan papers to induce the bank to make the loan, and then divert the loan proceeds to his or her own benefit.

At that point, the bank will consider whether coverage for its loss is available under its Financial Institution Bond.

The Role of the Financial Institution Bond

It is important to understand that while the Bond protects against some types of fraud losses, it is not designed to cover all fraud losses a bank can conceivably sustain. Generally speaking, losses that a bank is unable to prevent by sound underwriting and prudent business practices are within the scope of the Bond's

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SIDE NOTES

FREE COMPLIANCE TRAINING FOR EMPLOYEES OF ABA MEMBER BANKS:

Did you know that employees of ABA member banks can enroll in numerous online compliance courses, all complimentary as part of the ABA membership package?

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More than 100,000 bankers are enrolled in over 1 million courses. And remember, Frontline Compliance courses are free to ABA members.

For questions about Frontline Compliance and how to enroll, contact ABA's Eric Hensley at 1-800-BANKERS, ext. 5489 for more information.

To learn how to become an ABA member, we invite you to contact ABA's Karen Call at 1-800-BANKERS, ext. 5585.

intended coverage. And the converse is true: losses, even those caused by fraud, that sound banking practices *should have revealed*, will not be covered.

Loan losses are not covered under the Bond, except in circumscribed areas which, for purposes of this discussion, include:

- ≡ Insuring Agreement E—Securities and
- ≡ Insuring Agreement G—Fraudulent Mortgages.

Each of these coverages is quite specific—not general—and requires specific compliance with its terms.

For instance, **Insuring Agreement E** requires that the Insured have, *before credit is extended*, “actual physical possession” of the document (such as a mortgage or “evidence of debt”) which, in the wet funding scenario, will never be the case. And the document must be an “original,” not a fax or electronic version, as is sometimes the case even in dry funding.

There are a number of other, similar, requirements in both of these potential insuring agreements. For instance, both Insuring Agreements E and G require that:

- ≡ The Insured has acted “in good faith,” which has been held to require compliance with reasonable banking standards.
- ≡ the Insured have relied (or acted) “on the faith of” a specified list of documents—in other words, the bank must have relied on the documents, not merely on other, external factors such as whether the mortgage lender has a commitment to purchase from a secondary market investor. (Insuring Agreement G does not apply to forged documents at all.) And finally,
- ≡ the loss resulted directly from the covered peril for coverage.

These requirements, sometimes quite technical, are the subject of a growing body of case law, and of entire law review articles, and are beyond the scope of the discussion in this article, which is meant as an overview only.

Suffice it to say that banks that engage in warehouse lending should proceed with the utmost caution, and only do so after completing a thorough assessment of the risks involved. Most importantly, do not assume that fraud-related losses stemming from a warehouse lending operation will be covered under the terms and conditions of the bank’s Financial Institution Bond.

Beware of the pitfalls of warehouse lending, it might be riskier than you think.

Additional Reading

A law review article is available on the subject from Armstrong, McNeill & Reynolds: Warehouse Lending Losses Under the Financial Institution Bond, XII Fidelity Law Journal 1 (2006).

About the Author



Mark Gamin is a Senior Attorney with ABA Insurance Services, handling claims for the program for over thirteen years. Mark earned his law degree from Case Western Reserve University. Previously, he represented clients in legal matters including real estate, banking, insurance, and bankruptcy. A published author, he is past editor-in-chief of the American Bar Association’s Tort & Insurance Law Journal and is active in the Fidelity Law Association.

Insurance Definitions related to the Financial Institution Bond

Financial Institution Bond

The Financial Institution Bond from ABA Insurance Services provides fidelity coverage as required by financial institution regulatory agencies.

The following Insuring Agreements are referenced in the Warehouse Lending article:

Insuring Agreement E: Securities

This Insuring Agreement covers losses resulting directly from the bank extending credit on the faith of certain specified documents, including Stock Certificates, Deeds or like instruments, Certificates of Origin or Title, Guarantees, Evidences of Debt and Security Agreements, which are forged, altered, lost, stolen, or in some cases, counterfeit. Loan Participations Coverage may also be purchased. The bank must have relied in good faith upon the original instrument, and the bank or its authorized representative must have had *actual physical possession* of the written, original instrument prior to extending the credit.

Insuring Agreement G: Fraudulent Mortgages

This Insuring Agreement covers losses resulting directly from the bank accepting or acting upon real property mortgages, deeds of trust, and like instruments pertaining to real property on which a signature is legitimate, but was obtained through fraud, trick, or under false pretenses, rendering the document on which the signature appears defective. Insuring Agreement E only provides coverage if the document is forged, altered, lost or stolen.

To learn more about basic insurance terms and for claims examples, visit the “Coverage” section on our Web site: www.abais.com/coverage-overview.aspx.

\$4,000,000 profit-sharing distribution declared.

Total declaration amount of \$75,500,000 since 1991.

One of the unique features of working with ABA Insurance Services is the opportunity to participate in a profit-sharing distribution program from our mutual reinsurer, American Bankers Mutual Insurance Ltd. ABA member banks that purchase coverage through ABA Insurance Services are automatically eligible to participate in the program. Once again, American Bankers Mutual Insurance is proud to announce that it will distribute \$4,000,000 in underwriting profits this year to banks across the country. American Bankers Mutual Insurance has declared \$75,500,000 in distributions to eligible member banks since 1991.

“This marks the 21st consecutive year that the reinsurance company has distributed profits directly back to our member banks,” said John Manor, chairman of American Bankers Mutual Insurance Ltd. “This is a major achievement that is a source of pride for our company and a valuable benefit for ABA members.”

Customers receiving profit-sharing distribution checks will receive notification of the amount that their bank is receiving via fax in February. Checks will be distributed throughout March. **Bankers attending the ABA National Conference for Community Bankers in February will be able to pick up their bank's check at the ABA Insurance Services' booth in front of CAB Avenue in the program exhibit hall.**

For more information regarding this unique and rewarding feature of the ABA Insurance Services program, please feel free to contact us at 1-800-274-5222 or marketing@abais.com. To learn about the benefits of being a member of the American Bankers Association, call ABA Membership at 1-800-BANKERS.

Meet Lisa Micciche, our new Senior Underwriter.



Lisa Micciche is our new D&O and Bond Underwriter for Illinois. While new to our Underwriting Department, Lisa is actually a long-term employee of our group. Lisa has a strong analytical background, previously holding the position of Accounting Manager in our finance department. She is a tremendous asset to our underwriting team, bringing eleven years of audit, finance and management experience. Lisa earned her BS from Purdue University and is also a licensed CPA. Outside the office, she volunteers her time as a Big Sister and enjoys hiking in the National Parks.

If you have a bank in Illinois and have questions regarding coverages, feel free to contact Lisa at 1-800-274-5222 or lmicciche@abais.com.

ABA Insurance Services participates in community service events.



During the recent holiday season, ABA Insurance Services' employees contributed to and volunteered for three organizations: The Cleveland FoodBank, Adopt-A-Soldier and Adopt-A-Family. All employees eagerly participated, choosing the charitable effort that they wanted to serve.

One team volunteered an afternoon at the Cleveland FoodBank, northeast Ohio's organization dedicated to alleviating hunger by providing food and support to community hunger programs. In 2010, more than 600 programs across six counties received assistance from The Cleveland FoodBank. Our group sorted and boxed items to deliver to these programs.



Another team focused on collecting/purchasing, organizing and shipping care packages for seven soldiers serving overseas in different branches of the armed forces. Each soldier received two large boxes of health/hygiene necessities and comfort items including a variety of snacks, magazines, games and iPod gift cards. The soldiers sent thanks back home, letting us know that the boxes of goodies were received before Christmas and that everything was shared amongst their troops.

The third team visited an “adopted” family, bringing not only needed items, but also a Christmas tree and presents to brighten their holiday. Additional donations collected helped the local Adopt-A-Family organization support seven other local families in need who did not have sponsors of their own. We enjoy the opportunity to give back to the community. Thank you for your support.



Photo #1: Hal Cohen. Photo #2: Joe Aber, Otto Elkins and Melanie Comstock. Photo #3 (facing camera): Crystal Davis, Jim Trimpe, Foodbank assistant, John Cullen, and Mary Chamberlain. Photo #4: (back row) Mike Read, Shawn McNamara, Joe Haverstick, Dan Shand, Todd Steele, Bill Ericson, John Cullen, Mike Poremba and Anthony Narcise. (front row) Gina Juhnke, Ann Farkas, Lisa Kelly, Robin Barrett, Mary Chamberlain and Todd Evans.