

**STATEMENT**

of

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on

**DUE DILIGENCE IN MORTGAGE REPURCHASES AND FANNIE MAE:  
THE FIRST BENEFICIAL CASE**

before the

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATION  
FINANCIAL SERVICES COMMITTEE  
UNITED STATES HOUSE OF REPRESENTATIVES**

**March 10, 2005**

Madam Chair, Ranking Minority Member Mr. Gutierrez and Members of the Subcommittee,

I am pleased to represent the Office of Federal Housing Enterprise Oversight as you conduct oversight hearings on mortgage fraud. Director Falcon has given clear instructions to the staff—the General Counsel’s office and our examiners—to deploy the needed resources to address matters relating to mortgage fraud, including any misconduct by employees that results in losses related to mortgage fraud.

## **Introduction**

OFHEO as a safety and soundness regulator does not enforce criminal laws. OFHEO refers violations of criminal laws to federal or state agencies with appropriate jurisdiction for their review and action. Like bank regulators, however, OFHEO does inquire into the conduct of business operations, particularly to assure safe and sound practices. Criminal conduct by or against an Enterprise clearly is a threat to safe and sound operations. While the Enterprises are not charged with prosecuting firms or individuals engaged in fraudulent activities, they do have a role in identifying and reporting such parties.

As Assistant Director Swecker of the Criminal Investigative Division of the FBI testified before the Subcommittee on Housing and Community Opportunity last October, while the exact level of fraud related to mortgages bought and sold in the financial marketplace is not known, government and industry recognize an increasing prevalence of actual or suspected fraud. Much of this fraud occurs at the retail level that is between those seeking mortgages and banking and other financial institutions. Now, however, institutional players, be they small mortgage firms or others who operate in a wholesale environment—selling to banks and thrifts for their portfolios or for securitization or to government sponsored enterprises—have become an area of increased concern. This concern for “wholesale” or institutional fraud, coupled with technology and the large volume of mortgage and mortgage securities transactions requires increased vigilance by the industry, regulators and law enforcement.

OFHEO has been fortunate to be one of the agencies to be made a member of the President’s Task Force on Corporate Fraud. This task force, led by Deputy Attorney General James Comey, includes the Justice Department, the U.S. Attorney, the SEC, CFTC, IRS and others. We have learned much about fraud remediation and that inures to our benefit in seeking to enhance our efforts at fraud prevention; in other words, fraud prosecution has relevance for fraud prevention. Additionally, the Task Force has fostered cooperation and information sharing that has been most beneficial.

Regulators, law enforcement and the mortgage industry all have a vital role to play and a cooperative approach will prove the most productive.

OFHEO has been active in working on mortgage fraud. In the past, OFHEO sponsored a seminar on mortgage fraud training that included representatives of federal financial regulators, HUD, IRS and Ginnie Mae. Following on that, OFHEO examiners provided information sessions for the FBI at their Quantico facility detailing the who, when and how of mortgage fraud and the need for effective training for detection and prevention.

Now OFHEO has undertaken initiatives to improve mortgage fraud reporting and to address deficiencies that exist in Enterprise operations and systems.

### **Actions**

OFHEO recently moved to make formal what had been informal. Since his appointment, Director Falcon has made a top priority the formalization of OFHEO's regulatory and supervisory process. Where informality existed when OFHEO began operations in 1993, the Director has led an effort that has resulted in the creation of a broad regulatory framework that provides transparency to OFHEO's regulatory regime and greater guidance to the Enterprises.

In line with that effort, OFHEO has proposed, for public comment, a rule that will require the Enterprises to report on possible or actual mortgage fraud, to do so in a timely manner and to create the training programs and operating systems necessary to meet those obligations. The proposal calls for the Enterprises to inform OFHEO when they have a suspicion of mortgage fraud prior to requiring repurchase or refusing to purchase a mortgage, mortgage backed security or other financial instrument; they may continue with their transaction, if they determine appropriate, once OFHEO has been informed. In the past, such reporting occurred on an informal basis.

In addition, OFHEO has issued a guidance document to formalize reporting to OFHEO of lawsuits or investigations brought against the Enterprises in a timely manner so that OFHEO may exercise its oversight responsibilities and its supervisory role should changes in Enterprise operations be merited by litigation. This will help with early identification of court cases that involve the Enterprises including cases involving allegations of mortgage fraud.

The finalization of a rule on reporting mortgage fraud and the implementation of a reporting regime that includes both fraud as well as litigation matters should improve

reporting, lead to earlier intervention to avoid fraud and permit OFHEO to move expeditiously to introduce needed changes to Enterprise operations. I would note that we are well aware of the challenges in implementing a rule that provides OFHEO the information needed to do its job while being operationally smooth at the Enterprises and permitting them to meet their mission. I don't see any obstacles to addressing and meeting those challenges. We have worked before with the Enterprises on implementing protocols and in this matter we will work with them and have the benefit of inputs from law enforcement personnel.

As the public comment period is open on the rule, I would not discuss the rule in any greater detail as we must await comments and give them due consideration prior to issuing a final rule and requiring formal reporting to begin.

### **Benefits**

As this Subcommittee well knows, the enactment of the Bank Secrecy Act and the use of Suspicious Activity Reports have important elements for law enforcement. Congress has recognized as well their value as an important part of regulatory oversight. Banks today have two page SAR forms and supporting instructions on a wide range of consumer and business fraud incidents. The instructions highlight key forms of practices that should raise concerns and mortgage fraud requires similar descriptions and details. The Enterprises, engaging in a narrower band of business activities, will require the creation of forms and instructions by OFHEO tailored to their businesses and at the same time generating information that will benefit OFHEO's oversight and serve the purposes of law enforcement where appropriate.

While the Enterprises may not be the target of a large number of fraudulent transactions, the size of transactions alone must give one pause. One fraudulent event in a sizeable portfolio is a risk that merits action regardless of numbers. Also, their pivotal role in the mortgage finance system means that their public commitments to resist fraud and assist regulators will send a strong message to fraud perpetrators that getting past a bank will not get them home free and to institutions that there will be a watchful eye at OFHEO on attempts to pass worthless mortgages or bogus securities to the Enterprises.

It is my hope that the Enterprises will respond favorably to the mortgage fraud proposal and I believe we can work to achieve a goal of moving as close as possible to a "fraud free zone" at the GSEs. Realistically, this Subcommittee knows full well that fraud may be deterred, but not fully prevented; OFHEO is committed to making sure the deterrence is as strong as possible. I see no reason that the Enterprises would not share this view and work to implement a truly useful and effective mortgage fraud

reporting regime— one that functions well at an operational level while permitting them to meet their mission.

### **OFHEO's Role in Anti-Fraud Efforts**

The Bank Secrecy Act, which originally focused on government access to bank information and expanded to include anti-money laundering efforts, directs banks to provide information to regulators, but does not explicitly cover the Enterprises. It is my understanding that the Act at 31 USC 5312(a)(2)(Y) permits definition of other institutions as fitting within the purview of the statute. The fact that there is a specific list may have inhibited such a determination. Legislation may be needed to explicitly include the Enterprises.

A significant aspect of the Bank Secrecy Act, that was crafted in this Committee, was protection of a financial institution reporting on suspected or actual fraud from lawsuit by the party providing the information. Congress recognized that banks may make mistakes in good faith efforts to report activity that they think is suspicious; since the information is provided to the government, the Congress determined that the banks should not be sued for damages.

The General Counsel's Office is looking into a procedure whereby OFHEO would share information it develops on mortgage fraud with other government agencies. Clearly, the best approach may be specific legislation regarding coverage of the Enterprises under elements of the Bank Secrecy Act.

In addition, Congress may wish to consider whether other enhancements to the law may be beneficial. For instance, sections of Title 18 makes it a crime for individuals or institutions to make misrepresentations to secure credit or to engage in fraudulent transactions with a financial institution or a government agency.

Among these provisions are section 215 that addresses gifts or bribes to secure business with a financial institution, section 1011 that addresses false statements relating to sale of a mortgage to a Federal land bank, section 1012 that addresses making false statements or reports to or induces purchase of mortgages by the Department of Housing and Urban Development with the intent to defraud, section 1014 that deals with false statements or overvaluation of land, property or security to influence a decision by a financial institution and section 1344 that makes it a crime to defraud or obtain funds, credit or securities from a financial institution by false or fraudulent pretenses or representations. Whether such legislation would be beneficial, what form it should take and what unintended consequences should be avoided requires the deliberations of Congress and the expertise of the Justice Department.

## **Support**

OFHEO has benefited greatly from the expertise, information and views provided by the Treasury Department, Financial Crimes Enforcement Network (FinCEN), Federal Bureau of Investigation and the U.S. Attorney. Coming from the private sector and hearing of jurisdictional squabbles, I can report in this instance strong cooperation among agencies and I am pleased to have the commitment of these experts as we move forward towards a final rule and implementation of the rule's requirements.

## **A Note on First Beneficial**

OFHEO's review of the First Beneficial case is the subject of an ongoing examination. We are seeking to determine whether Fannie Mae's operations in 1998 and 1999, when the bulk of the fraudulent business with First Beneficial occurred, were excessively decentralized and uncontrolled, lacked adequate reporting and quality control, failed to distinguish functions between business development and problem workouts and generally did not hold regional offices sufficiently accountable. Likewise, our examination is looking into whether Fannie Mae personnel involved with First Beneficial may have qualified the company as an approved seller-servicer, but did not take effective action to remedy deficiencies they discovered or to act timely to end their relationship. At present we have no indication that the regional office reported on their dealings to headquarters, which in turn would have been expected to provide such information to OFHEO.

OFHEO currently is reviewing changes that Fannie Mae has undertaken, whether the changes are adequate and, as well, to see if enhancements are needed. In particular, OFHEO believes that a strong set of guidance documents, backed by a strong and centralized compliance regime, is essential regardless of whether the business model provides for centralized or decentralized operations.

The Enterprises should always strive for best practices in seeking to avoid mortgage fraud and a strong, aggressive program aimed at prevention and detection is imperative for safe and sound operations.

Again, thank you for this opportunity to appear before the Subcommittee.