

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

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
OVERSIGHT AND INVESTIGATIONS  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED NINTH CONGRESS  
FIRST SESSION

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MARCH 10, 2005  
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**Thursday, March 10, 2005**

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairwoman of the subcommittee] presiding.

Present: Representatives Kelly, Kennedy, Garrett, Fitzpatrick, Davis of Kentucky, Oxley, Baker, Gutierrez, Moore of Kansas, Maloney, Cleaver, and Moore of Wisconsin.

Mrs. KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order.

A bit of housekeeping before we actually begin. We are going to be called to the floor for a vote and the swearing-in of Doris Matsui, who won an election in California last night. So we will start the hearing, but I am going to have to recess the hearing temporarily for us to be able to do that. I wanted to explain that before we actually got into the deep of this.

The committee is meeting today to hear testimony about the transfer of nonperforming financial instruments between First Beneficial and Ginnie Mae, with the knowledge of Fannie Mae. This transaction between a GSE, a wholly owned government corporation, and a private lender exposed taxpayers, investors and homeowners to harm and threatened the transparency and integrity of the financial networks that support homeownership in the United States.

On December 22, 2004 I joined Chairman Ney and Chairman Baker in sending a letter to Fannie Mae requesting an accounting of its behavior in this case. The Office of Federal Housing Enterprise Oversight, the OFHEO, is now proposing new rules to require Fannie Mae to report its awareness of fraud and corruption. It should not take federal regulation to get Fannie Mae or any other well-run public company to exercise its responsibility as a corporate citizen to report possible wrongdoing and protect taxpayers. I am hopeful that this hearing will lead to better institutional controls within Fannie Mae and the industry in general, and government to prevent fraud and secure the safety and homeownership in the United States of America.

I now yield to the ranking member of the subcommittee, the gentleman from Illinois, for an opening statement.

Mr. GUTIERREZ. Good morning, and thank you, Chairwoman Kelly for calling this hearing today, "Due diligence in mortgage repurchases and Fannie Mae: The first Beneficial Mortgage case." I have to say that it appears that the relationship with this institution was beneficial to no one.

I have just started reading a book called "Thank You for Smoking," by Christopher Buckley, a satire of the tobacco lobbyists, which they are currently making into a movie. I am told later in the book, a hearing is held in the Senate Committee on Hindsight. That is an easy shot at Congress. Most of us do what we do here necessarily in hindsight because we rarely are seeking to fix a problem that has yet to occur. While it is important for us to examine what happened, both in general here on the Oversight Committee, and in this specific instance at First Beneficial, it is even more important that we not spend all of our efforts in looking backwards. We must learn from these events and work to improve the landscape as we move forward with solutions, either through legislation or working with regulators or both.

The fraudulent conduct at First Beneficial has been the subject of a court case. The criminals have been sent to jail. Fannie Mae has reorganized its operation and improved its information sharing, as indeed the entire industry did after September 11. They have provided some restitution to Ginnie Mae. OFHEO has recently issued a new proposed rule that would require GSEs to report possible mortgage fraud in a timely matter so that damage can be limited. It appears that we may need to amend the Bank Secrecy Act to ensure that GSEs are shielded from liability in this instance when they report potential fraud to their regulator or law enforcement bodies.

I look forward to hearing from the witnesses regarding the lessons learned from the First Beneficial experience, and recommendations to detect and combat mortgage fraud as we move forward.

I yield back the balance of my time.

Mrs. KELLY. Thank you. Have you finished, Mr. Gutierrez?

Mr. GUTIERREZ. Yes.

Mrs. KELLY. Thank you.

Mr. Fitzpatrick, you have no opening statement. Is that correct?

I think we should begin with you, Mr. Donohue. If you have not testified before, there is a box on your table. When you start talking, that box will turn a green light on. When there is a yellow light, that means that you have one minute to sum up. With the red light, that means that you are asked to please sum up and end your testimony.

I think we have time, depending on how long you talk, Mr. Donohue, I think we have time to start with you. Thank you. Mr. Donohue, please pull that microphone close to you and make sure it is on. I am not sure it is on. Push the button in front.



**STATEMENT OF HON. KENNETH M. DONOHUE, SR., INSPECTOR  
GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. DONOHUE. Madam Chairwoman Kelly, ranking member Gutierrez, and other members of the subcommittee, good morning. I am pleased to have this opportunity to bring to the subcommittee's attention the facts surrounding a recent case developed by the HUD Office of Inspector General and other law enforcement agencies against First Beneficial Mortgage Corporation of Charlotte, North Carolina and its importance as an area of concern for government-sponsored enterprises, regulatory agencies and those that oversee these organizations.

Of importance are the crimes of the owners and the associates of First Beneficial, but also important is the lack of due diligence by some to take action to mitigate harm against the government. For whatever reasons, Fannie Mae did not pass information on First Beneficial's transgressions to others, which allowed First Beneficial to continue to operate and to issue over \$7.5 million in fraudulent mortgage-backed securities guaranteed by Ginnie Mae.

On the easel is a flow chart of the case which shows in a compressed fashion the timeline of the events I will now discuss. Fannie Mae approved First Beneficial as a single-family mortgage lender in 1995. In 1997, First Beneficial was approved to sell Title I loans. Title I loans are home improvement loans and manufactured housing loans. In 1998, Fannie Mae was noticing problems with the Title I loan program nationwide, and decided to review First Beneficial's loan portfolio. This review uncovered approximately \$1 million in ineligible Title I loans to people without FHA-insured mortgages.

During this review, First Beneficial was not truthful about whether the Title I loans were FHA-insured. At this time, Fannie Mae demanded that First Beneficial repurchase the portfolio, but First Beneficial did not have the funds to repurchase. Fannie Mae worked out a deal where they would purchase new pre-approved single-family loans from First Beneficial and apply the proceeds from the sale of these loans to repurchase the ineligible Title I loans. Fannie Mae placed an in-house suspension on First Beneficial at this time.

After a few weeks, First Beneficial called Fannie Mae and said they had an investor who was willing to buy the bad Title I loans with a single cash payment. Accordingly, in September of 1998, First Beneficial paid Fannie Mae back the nearly \$1 million. At this point in 1998, Fannie Mae did become suspicious of First Beneficial's single-family loans as well, and began an inquiry into those it had purchased. They found that many loans were in the names of First Beneficial's owners and employees, and that should have caused Fannie Mae's concern.

First Beneficial said the loans were investor loans and that they would repurchase them. On November 3, 1998, Fannie Mae wrote First Beneficial and said they would not purchase any more of these loans without prior approval. On November 19, 1998, Fannie Mae received a telephone call from a financial crimes investigator with the North Carolina Banking Commission who told them that First Beneficial was making loans without insurance and that First

Beneficial was trying to get Ginnie Mae to buy the loans. The investigator gave Fannie Mae the names of the two First Beneficial employees who confirmed their effort to sell loans to Ginnie Mae.

Fannie Mae learned that First Beneficial had only two investor sources, Ginnie Mae and Fannie Mae. On November 20, 1998, Fannie Mae suspended First Beneficial as a lender and called in the owner for a meeting. At this meeting, Fannie allegedly wanted to know more about the investors, but received no response from First Beneficial. Following this meeting, Fannie Mae did some review by taking the addresses of properties in the loan portfolio and going out to inspect. What they discovered was that many of the properties listed were in fact vacant lots. A check of the courthouse revealed that the main borrowers did not own the properties and that some were not even owned by First Beneficial.

At this point, it is my understanding Fannie was not under any legal obligation to notify Ginnie Mae, OFHEO or any law enforcement agency such as the OIG of the FBI. However, I do believe that a good corporate citizen should have done so. As you can see, First Beneficial sold a pool of loans which were fraudulent to Ginnie Mae investors on December 11, 1998 in order to repurchase on December 18, 1998, the same fraudulent loans from Ginnie Mae. In late 2000, Ginnie Mae discovered these transactions through a subsequent compliance audit. Because Fannie Mae did not tell Ginnie Mae of the dubious scruples of these lenders, the original fraud to Ginnie Mae ballooned in costs to Ginnie Mae. By the time it was all said and done, the American taxpayer was defrauded out of approximately \$38 million.

Essential to the scheme was the requirement that First Beneficial provide a mortgage document to Ginnie Mae's document custodian. For example, there was a property listed at 9108 Pleasant Ridge, Charlotte, North Carolina. The note appeared to be at first glance a normal mortgage note. In reality, there was no such mortgage and the signature belonged to a relative of the owner of First Beneficial. The collateral listed on the note was a vacant lot not owned by the stated mortgagor.

Four primary defendants have been convicted and sentenced. Defendant McLean was sentenced to 21 years in prison and \$23.5 million in restitution has been ordered. Some might say this case is about a small amount or could be interpreted as a cost of doing business, particularly as it relates to the vast funds in the securities market. But you can see from the severe sentences that the court viewed this case as a serious matter. The full faith and credit of the United States stands behind Ginnie Mae and it is the integrity of the program that investors rely upon. No rule or regulation or law exists that made it incumbent on Fannie Mae to have told others about what they discovered. If they had, it may have saved taxpayers millions of dollars.

Mrs. KELLY. Mr. Donohue, I reluctantly am going to have to ask you to sum up.

Mr. DONOHUE. In sum up, Madam Chairman, I have spent some time with the Resolution Trust Corporation. During that time, we learned many different things from the failed savings and loans. One of the primary issues was the fact of the coordination effort that must exist between the regulatory agencies, between the en-

terprises, and between law enforcement and affected organizations. It seems to be the benchmark of this matter. As a result of that, I think that is, if I leave any thought here today, it is incumbent upon us to make sure that these types of matters do not happen again.

I must say finally to thank my colleagues at the FBI and the IRS Criminal Division in the Department of Justice for their assistance in this case.

Thank you.

[The prepared statement of Hon. Kenneth M. Donohue, Sr. can be found on page 37 in the appendix.]

Mrs. KELLY. I thank you very much. For the record, Mr. Kenneth M. Donohue, Sr., is the Inspector General from the Department of Housing and Urban Development.

Thank you very much for your testimony.

We have been called for this vote. I am going to reluctantly recess. I would imagine it will take us probably 15 to 20 minutes, and then we will be back as soon as possible. Thank you for your patience.

[Recess.]

Mrs. KELLY. Thank you for your indulgence. We have a new Congresswoman.

Mr. Donohue has given us his testimony. We now will hear from Samuel Smith, the Vice President of Single-Family Operations for Fannie Mae. John Kennedy is next, Associate General Counsel of HUD, representing Ginnie Mae; and Alfred Pollard, General Counsel of the Office of Federal Housing Enterprise Oversight, the OFHEO. Mr. Pollard is a veteran of Capitol Hill and on the faculty at Georgetown University School of Business.

We welcome all three of you, and all four of you. We will continue with you, Mr. Smith.

**STATEMENT OF SAMUEL SMITH III, VICE PRESIDENT, SINGLE FAMILY OPERATIONS, FEDERAL NATIONAL MORTGAGE ASSOCIATION**

Mr. SMITH. Thank you, Chairwoman Kelly, ranking member Gutierrez, and members of the subcommittee.

My name is Sam Smith. I am Vice President of Single Family Operations for Fannie Mae, and I have worked in Fannie Mae's Atlanta office since 1973. In my capacity as Vice President, I am currently responsible for the quality and underwriting of loans sold to Fannie Mae by lenders assigned to Fannie Mae's Eastern Business Center.

I welcome this opportunity to speak on mortgage fraud generally and also about issues arising out of the First Beneficial Mortgage Company matter. I want to thank the subcommittee for holding this hearing and for inviting me to be here today. I have prepared a written statement that I request be made part of the official hearing record.

Fannie Mae takes the issue of mortgage fraud very seriously and has taken many significant steps since 1998 to improve its anti-fraud efforts. First Beneficial was a case involving institution-level "fraud for profit." Looking back upon the First Beneficial case with the benefit of 20/20 hindsight, there is no doubt we could have han-

dled the lender relationship differently and better. As the Vice President in charge of the single family business for the Atlanta office at the time, I take full responsibility for my actions and for those of my team regarding First Beneficial.

I have set forth in my written testimony a detailed account of my involvement in the First Beneficial case. Fannie Mae also engaged the law firm of Latham and Watkins to review how the matter was handled, and I would like to request that a copy of their detailed report, which was made available to the committee earlier this week, be made part of the record.

Mrs. KELLY. With unanimous consent, so moved.

Mr. SMITH. Thank you.

These documents outline in detail the chronology of the facts as we know them. I welcome the subcommittee's questions with respect to the materials and the actions the company took during this period. However, I would like to address one fundamental issue. The subcommittee's invitation to me asks whether Fannie Mae staff knew that First Beneficial was perpetrating fraud against Ginnie Mae in order to secure repurchase funds for Fannie Mae. As the Latham and Watkins investigation concludes, the answer is that we did not know. However, looking back on the totality of the facts and learning the information that came out in the trial of James McLean, at which I testified as a government witness, I regret that there were signs that we missed and that we did not take more rigorous steps to further investigate First Beneficial's activities in 1998.

Under the policies and procedures now in place at Fannie Mae, I am confident that the First Beneficial matter would be handled much differently today. In 1998, when First Beneficial's loan issues arose, Fannie Mae's regional offices handled loan deficiencies and instances of suspected fraud on a case-by-case basis. Since that time, Fannie Mae's operations and policies have evolved with changes in the marketplace, and we have strengthened a number of our operations and anti-fraud policies.

First, we have adopted a company-wide anti-fraud policy. We are also implementing enhancements to our internal operational controls to further clarify roles, responsibilities and notification requirements on fraud matters. These internal protocols will immediately elevate patterns that suggest possible fraud to senior management and to our legal and compliance offices.

Second, Fannie Mae has changed its requirements for approving lenders as seller-servicers, and has moved to a more centralized approval process that can, among other things, focus on the needs of smaller lenders in meeting the seller-servicer requirements.

Third, as a result of changes in technology and in an effort to ensure consistency and leverage resources, the post-closing file review of all loans sold to Fannie Mae has been centralized. We now employ a systematic sampling model to select both newly delivered and defaulted loan files for review every month. For every loan delivered to our company, lenders contractually represent and warrant that the loans meet our credit, documentation and underwriting standards. If a loan does not meet those standards, the lender knows it may be obligated to repurchase the loan, reimburse us for losses, or take other corrective action.

This contractual repurchase obligation provides incentive for lenders to implement procedures for quality underwriting and is one of the ways Fannie Mae manages the safety and soundness of its investments, manages its charter compliance obligations, and discourages inappropriate loan underwriting of all types. We have also created an investigations team that is focused on mortgage loan fraud reviews and reporting.

Fourth, Fannie Mae is undertaking extensive efforts to assist our lenders in detecting and combating fraud by developing and encouraging the use of fraud detection tools at the point of sale through our automated underwriting system, Desktop Underwriter.

Finally, as noted above, fraud is an industry-wide problem. Fannie Mae is working cooperatively with OFHEO on its recent proposed regulation regarding mortgage fraud reporting. We have stated publicly that we will work with Congress, HUD and law enforcement agencies to establish an appropriate process for sharing information. In addition, we are working closely with others in the industry to confront this growing problem, including participating today in the Mortgage Bankers Association's summit on mortgage fraud. And we join with others in the industry in supporting legislative enactment through GSE reform legislation or otherwise of a requirement for mortgage fraud reporting, including a safe harbor from legal liability for reporters of potential fraud and an appropriate approach for increased information-sharing between government and industry.

Thank you for inviting me here today, and I look forward to responding to your questions on these matters.

[The prepared statement of Samuel Smith III can be found on page 53 in the appendix.]

Mrs. KELLY. Thank you, Mr. Smith.  
Mr. Kennedy?

**STATEMENT OF JOHN P. KENNEDY, ASSOCIATE GENERAL COUNSEL, OFFICE OF FINANCE AND REGULATORY COMPLIANCE, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. KENNEDY. Chairman Kelly, ranking member Gutierrez and distinguished members of the committee, I am John P. Kennedy, associate general counsel for finance and regulatory compliance at the Department of Housing and Urban Development, and Senior Counsel to Ginnie Mae. I have been at HUD for approximately 35 years.

I am going to start this story from my point of view in terms of the Ginnie Mae involvement in this matter in late August of the year 2000. In a scheduled compliance first audit of First Beneficial, the auditor, Deloitte and Touche, started to get some indications that the records at First Beneficial were giving indications of serious problems. Ginnie Mae immediately put together what we call a default team, and deployed that team to Charlotte, North Carolina.

At that same time, Ginnie Mae was in a position to declare default under the guaranty agreement with First Beneficial, and that was the purpose of the team's going there. It became apparent almost immediately that it was not just a contractual enforcement

case. The initial findings, the draft findings of Deloitte and Touche made it clear to us that we had a potential criminal matter. At that point, immediately the Department of HUD, the General Counsel's office in Ginnie Mae, started to cooperate in working with the U.S. Attorney, not the Civil Division, the Criminal Division, in order to give them whatever technical assistance that we could to proceed with the criminal case. The IG was also notified and immediately deployed its IG investigators, not auditors, investigators to Charlotte, North Carolina to assist in the investigation.

Probably the telling fact for us was that we noticed that we looked at 42 properties and determined that 37 of the properties were either vacant properties or properties under construction, clearly, not a case where you could have a mortgagor that would be appropriate for an FHA-insured mortgage in a Ginnie Mae pool.

So at that point, we were mostly providing assistance to the U.S. Attorney to prepare the search and seizure warrant for the records of First Beneficial. Within a period of a little over 3 days, the Ginnie Mae team went from a contractual enforcement case to assistance on a criminal matter, and a search and seizure of the records. On the same day that the search and seizure warrants were issued, Ginnie Mae also delivered its default letter. That happened on the same day and Ginnie Mae declared them in default and in essence took over the bank accounts, the records and all records pertaining to the mortgages in the pools.

At the same time, on literally day two of that, the attorney that was representing Ginnie Mae at that point, was looking at the public records to identify all assets, personal and real, of First Beneficial and its principals for the purposes of seizing those records to ultimately to satisfy any losses that would pertain to Ginnie Mae in the pools.

The FBI, HUD's IG and the IRS, of course, then conducted a lengthy and extremely tedious and detailed investigation of the operations of First Beneficial. The outcome of that, as you know and has been stated, are convictions and terms of 21 years for the principals.

In a rather unusual situation, Ron Rosenfeld, the President of Ginnie Mae, actually flew to North Carolina to attend the sentencing hearing. Obviously, this was a case of significance to Ginnie Mae. A large financial loss did occur because of the actions or, or inaction of First Beneficial. It is the only time in my 35 years that I have seen a President of Ginnie Mae actually go to a sentencing hearing and present his testimony to make sure the judge understood the gravity of this case.

I would also note, and I do not think it has been mentioned yet, that the accountant for First Beneficial was also indicted and convicted. That becomes relevant because when you have a situation where the chief operating officer and the accountant worked together in a scheme to defraud, it is going to make it difficult for everybody. It is going to make it more difficult for people to find that fraud. But that case was handled, the IG assisted in that, and the person has been convicted and is serving a sentence of one year under a plea agreement.

At that point, when all of the criminal action was over, that is when we started focusing, "we" Ginnie Mae and OGC, started fo-

ocusing on well, how do we recover the monies for Ginnie Mae. They suffered extensive losses. We started looking at different theories and different opportunities for capturing monies that were a part of the criminal conspiracy. Let me just say that on January 16, 2004, I visited main Justice, the Department of Justice, Mike Hurd, Civil Fraud Section, and we started thinking about different theories under which we could recover monies.

As I said in the very beginning, we had identified all of the assets of First Beneficial, and that is roughly \$8 million. I should say that in that regard, we identified 100 parcels of property, 20 bank accounts, 7 vehicles, a boat and the personal residence of the owners of the company. All of that was available to us in a forfeiture process. That has since, through the U.S. Attorney's office, come to fruition, and \$300,000 has been paid already to other victims, and at the end of the day the remaining monies of that \$8 million will come to Ginnie Mae to satisfy that.

More importantly, I think, we started looking at the facts that were available to us from the criminal case. When we looked at the facts surrounding Fannie Mae's behavior, it occurred to us that possibly that might be an avenue that we could look at. That was the purpose of my visit to the Department of Justice, and over a period of months, we ended up working with them, an incredible effort on the part of the Department of Justice and the U.S. Attorney's office, Paul Taylor specifically in the U.S. Attorney's office, a criminal forfeiture case was filed. The outcome of that, as you already know, was that Fannie Mae looked at that. They looked at the evidence surrounding that that was available to them, and elected to pay \$7.5 million, which included \$1 million in interest.

In terms of the acts or omissions of Fannie Mae, my look at the evidence convinced me that at a minimum they either did know or should have known that Fannie Mae was going to be the ultimate victim of this fraud scheme that they did not report.

[The prepared statement of John P. Kennedy can be found on page 44 in the appendix.]

Mrs. KELLY. Thank you, Mr. Kennedy.  
Mr. Pollard?

**STATEMENT OF ALFRED M. POLLARD, GENERAL COUNSEL,  
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

Mr. POLLARD. Madam Chair, ranking member Gutierrez, and members of the subcommittee, I am pleased to represent the Office of Federal Housing Enterprise oversight as you conduct these hearings. 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 involving Fannie Mae and Freddie Mac, including any misconduct by employees.

OFHEO as a safety and soundness regulator does not enforce criminal laws. OFHEO refers violation 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.

OFHEO has been fortunate to be one of the agencies to be made a member of the President's Task Force on Corporate Fraud led by Deputy Attorney General James Comey. This includes the Justice Department, U.S. Attorneys, 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.

OFHEO has been active in working on mortgage fraud. In the past, we have sponsored seminars on mortgage fraud that included some of our colleagues at the table today, and has even provided a training program for the FBI at their Quantico facility. Now, OFHEO has undertaken initiatives to improve mortgage fraud reporting and to address deficiencies that exist in enterprise operations and systems.

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 finalization of a rule on reporting mortgage fraud and the implementation of a reporting regime should improve overall reporting, lead to earlier intervention to avoid fraud, and permit OFHEO to expeditiously 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 do not see any obstacles to addressing and meeting those challenges and we will work with the enterprises, as well as with regulators and law enforcement personnel.

As the public comment period is open on the rule, I will not discuss the rule in any greater detail as we must await those comments and give them due consideration prior to issuance of a final rule and implementing the formal reporting.

As this subcommittee well knows, the enactment of the Bank Secrecy Act and the use of suspicious activities reports have important elements in law enforcement, likewise for regulators. Banks today have SAR forms and supporting instructions on a wide range of consumer and business fraud. The instructions highlight key forms of practices that should raise concerns. 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 needed by us and by law enforcement.

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. We are committed to making sure the deterrence is as strong as possible.

You have heard comments on the Bank Secrecy Act, on the need for safe harbor and other provisions. OFHEO believes that would be useful. The General Counsel's office is looking in to a procedure where OFHEO would share information it develops on mortgage



fraud with other government agencies. I would note we have benefited greatly from the expertise, information and views provided by the Treasury Department, Financial Crimes Enforcement Network, 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 toward a final rule and implementation.

On First Beneficial, I will note in my remaining 20 seconds, that we are currently reviewing changes that Fannie Mae has undertaken to determine if those changes are adequate, but as well to see if enhancements are needed. In particular, we believe that a strong set of guidance documents, backed by a strong and centralized compliance regime, is essential regardless of whether a business model provides for centralized or decentralized operations.

In sum, both enterprises should 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, I appreciate the opportunity to appear before you.

[The prepared statement of Alfred M. Pollard can be found on page 47 in the appendix.]

Mrs. KELLY. Thank you very much, Mr. Pollard.

Just so you gentlemen know, your full written statements will be made part of the record.

Mr. Donohue, following your examination of the facts that surrounded the First Beneficial matter, would you consider Fannie Mae's internal controls to be adequate in identifying and reporting fraud?

Mr. DONOHUE. Well, first of all, as you well know, I have no statutory authority over Fannie Mae as far as what they are proposing to do, but I have made comments, as was discussed by the OFHEO representative, as far as the new proposed regulation.

Mrs. KELLY. I thank you very much. If you have suggestions, we would like to work with you.

I have reached over here, because I have a sworn statement from Mark Heimbach, Special Agent, United States Department of Housing and Urban Development. He is from your office. In this sworn statement, he discusses something that I am going to talk with you, Mr. Smith, about. You say you regret your lack of knowledge about this. According to this, Mark Heimbach says prior to Fannie Mae receiving these transfers, Fannie Mae officials were aware that the source of these funds was Ginnie Mae and that the McLeans had repaid this money to Fannie Mae simply by re-selling the fraudulent loan packages to Ginnie Mae and thereby defrauding that entity.

That is a sworn statement, sir. I know you regret the lack of knowledge, but apparently someone there had knowledge. To that end, Mr. Baker and Mr. Ney and I sent a letter to Fannie Mae in December of 2004 asking if Fannie Mae was aware of any other instances where an entity of the Federal Government was sold fraudulent loans held at one time by the enterprise. In its response, Fannie Mae exempted loans that it assigned to the Federal Government in connection with insurance claims. Why did Fannie Mae's

Atlanta office employees fail to inform, and what do you know about that statement that I just gave you? What can you tell us about the fact that you, in the response, exempted loans that you assigned to the Federal Government in connection with insurance claims?

Mr. SMITH. Well, as the Latham and Watkins support shows, there was an e-mail message from Debra Brown to me and a few other people at Fannie Mae which had an attachment. The attachment described some conversations that Debra Brown had with the North Carolina Banking Commission, along with two employees, or two people that represented themselves as employees of First Beneficial. In that attachment to that e-mail message there was a reference, a couple of references, to First Beneficial's intention to sell loans to Ginnie Mae.

Now, I do not recall seeing that e-mail message or the attachment until much later, actually in 2001, after Fannie Mae's records had been subpoenaed by the government as it was preparing its case against James McLean. Fannie Mae responded to the subpoena and gave the government all of our records. Government attorneys came to Fannie Mae's office in Atlanta and asked me about that e-mail message. I was shocked at the time to see those references in the attachment to the e-mail message. I do not remember seeing the e-mail message or the attachment in 1998.

I do recall discussions with my staff and especially with Debra Brown, about the phone calls that she had from the North Carolina Banking Commission and the two employees, but the focus of those discussions was that the North Carolina Banking Commission and the two employees were pointing to activities at First Beneficial that they felt were improper. I do not recall at the time any discussions about Ginnie Mae. In fact, the Latham and Watkins report interviewed a number of people, some of whom have left Fannie Mae years ago, but who were there at the time of this situation. None of us recall any conversation about the reference to Ginnie Mae.

So yes, in retrospect, now looking at the facts, the file does show that there was in an attachment to a single e-mail message a reference to Ginnie Mae, but none of us at Fannie Mae can recall ever discussing that or having knowledge that James McLean intended to sell loans to Ginnie Mae. In fact, in October of 2000, when I received a copy of HUD's letter to First Beneficial suspending or terminating them, I can recall shock and disbelief that a small lender like First Beneficial Mortgage had even been approved to do business with Ginnie Mae. That was the first revelation that I had, the first information that I can remember when I first became aware that First Beneficial had been involved with Ginnie Mae.

Mrs. KELLY. Yet the testimony of Debra Brown indicates that on or about November 19, 1998, she took a call from a man named Warren Harper, the federal crimes investigator with the North Carolina Banking Commission. To sum up that testimony, the indication in that conversation was that they were trying to get Ginnie to buy loans now. They were trying to buy them out of Fannie to Ginnie. So there was someone there who was an employee who Debra Brown seemed to know about it. I would like to ask you, Mr. Donohue, if you would respond to what Mr. Smith just said.

Mr. DONOHUE. I think I misunderstood your question before. I would love to respond. It is my feeling, in looking over the record myself and reviewing and speaking to our investigative personnel, it certainly does appear to be the preponderance of the facts in my mind that Fannie knew that these securities were destined to Ginnie Mae based on these comments, based on the North Carolina investigator, and based on the correspondence that went on discussion with regard to other people that provided testimony.

So my feeling is, to answer your question, yes I do believe that reasonably so there was a preponderance that Fannie knew that these were destined for Ginnie, and as a result, as I have been quoted, I felt they should have notified Ginnie as appropriate.

Mrs. KELLY. Thank you very much.

I am out of time. I will turn to Mr. Gutierrez.

Gentlemen, I wanted to let you know that we have been joined by Chairman Oxley. I am delighted to see him here as well.

Mr. Gutierrez?

Mr. GUTIERREZ. Thank you.

Thank you, gentlemen, for your testimony this morning. I do not think we are going to figure out when Fannie Mae knew or whether they knew exactly, because it just seems to me that if Mr. Donohue is correct, then Mr. Smith lied to the FBI and to the U.S. Attorney's office. We have his sworn testimony here. He also lied at trial. I do not know of any investigation of the Federal Government into Mr. Smith or the collusion. I mean, it would have to be a pretty broad-based conspiracy at Fannie Mae, not only between Mr. Smith and Mr. Smith and other former employees and current employees at Fannie Mae. They all have to be in collusion. I am not trying to say that they cannot do that, but given the extensive investigation that has been done. As a matter of fact, then, the Federal Government had Mr. Smith testify on their behalf against First Beneficial.

So I guess the Federal Government might have thought then that he was lying and used him as a witness in the case against First Beneficial. I am not a lawyer. I am just listening to the testimony of everyone here today.

So I think there is certainly enough reason to suspect that Fannie Mae should have known better, that they should have been more judicious, because as I look at this, and I will just ask anybody, when Fannie Mae went to First Beneficial, and said First Beneficial, you know, we just can't. We want you to repurchase this portfolio that we have with you. It was not because they had done something illegal. Otherwise, it seems to me Fannie Mae would have turned them over for criminal prosecution. They said it does not fit our underwriting guidelines; you do not have proper documentation; you have shoddy paperwork here; we do not want these loans.

And indeed, we have the gentleman from First Beneficial, the former CEO, saying to Fannie Mae, we will get the money from subprime lenders; we will get the money from these people. That is the testimony at trial that that is where you are going to get the money. So there were other reasons given for the testimony.

So if there was no criminal, and I have not read anything in the record that Fannie Mae knew of any criminal involvement or activ-

ity of First Beneficial, that this was an underwriting issue and that they did not want to keep these loans, and they were asking them to basically give their money back to Fannie Mae, and saying we do not want these loans, and they have to go out and get those loans. Otherwise, it would seem to me that they would know about it.

So as I look at this, I guess my question is, Mr. Smith, what would happen differently today, corporation, bank, First Beneficial, you have \$7.5 million in loans or money owed to you. How would you do things differently today and what changes have been made to do things differently today so that another governmental agency, Ginnie Mae, or as a matter of fact, any others, they are all insured by us, that you would not be able to take loans and simply allow someone else to take them up?

Mr. SMITH. Certainly, there is an extreme heightened sense of awareness at Fannie Mae about all matters pertaining to fraud. Fannie Mae has implemented a corporate-wide anti-fraud policy in writing that requires every employee when they have knowledge or suspect fraud, to take action and report it.

We have also centralized our lender approval process into a single office that will allow that office to better focus on the needs of smaller lenders and to properly judge those lenders and their qualifications to be Fannie Mae-approved lenders. We have also centralized our review of individual files in our Dallas office. We have implemented some models which are designed to try to target for review those files that would perhaps have some indicators of irregularities.

Also in the Dallas office we have created a fraud investigation team that when they pick up on the potential for fraudulent activity, they will do investigations and find out exactly what is going on. We have also implemented in our automated underwriting tool, Desktop Underwriter, some fraud detection tools designed to help our lenders at point of sale spot potential fraudulent activity.

Mr. GUTIERREZ. Let me just ask you a follow-up question, as my time has expired. Does Fannie Mae expose itself to liability when it reports possible fraud that turns out to be botched paperwork? Could Fannie Mae be sued for libel?

Mr. SMITH. That has certainly been on my mind when I have dealt with some of these issues. When we were working with First Beneficial, First Beneficial represented that the ineligible loans were due to misunderstandings and poor management. If I had, on my own, taken actions that were inappropriate in retrospect, and in fact if James McLean's claims had been valid and he could prove—

Mr. GUTIERREZ. Let me just say this. I do not want to go over. The gentelady has been very kind with me this morning. Let me just say that there are those of us in Congress and across the country that count on Fannie Mae to do the kind of work that allows people to purchase homes and to rebuild neighborhoods. Let me just say that while I believe you, I certainly think that Fannie Mae needs to do a lot. I want you to do well.

I look at the record. I can see there are mistakes. But even when you make a mistake, you made a mistake. I think you admit you made a mistake and there are consequences to mistakes. And we

do not want you to make these mistakes any further because they harm the American public and the American investing community, and they harm the goals and the purposes that Congress when they enacted and made you what you are today, and gave you the authority to do what you do today.

So let me just say that I believe you, but I can understand why others might not. I certainly hope that in the future you take much more aggressive action when you see that loans, these were suspicious loans that you did not want in your portfolio. Before you get rid of something, and you say I do not really want this, that you figure out how to just not get harmed by what you do not want.

Thank you very much for your testimony this morning.

Mrs. KELLY. Thank you, Mr. Gutierrez.

Mr. Oxley?

Mr. OXLEY. Thank you, Madam Chairwoman. Thank you for your leadership on this important issue.

Mr. SMITH, it is my understanding that in 1998 once a lender was approved to sell Title I notes, you would cease further due diligence regarding the underlying basis for the loans, and instead, Fannie would rely on the lender's approval status and assurances outlined in your contract for sale. Was this substantially the standard operating procedure then?

Mr. SMITH. Yes. After a lender becomes approved, we rely on lender warranties. The lender by selling loans to Fannie Mae warrants that the loans meet Fannie Mae's standards.

Mr. OXLEY. And what role at that point did the Fannie Mae headquarters play when the fraud was detected?

Mr. SMITH. The regional offices back in 1998 handled repurchase issues, matters involving ineligible loans, investigations, pretty much on its own and was under no obligation to inform the Washington office or seek advice from Washington unless we felt it was necessary.

Mr. OXLEY. Could you take the committee through the structured changes that have been made structurally so that if the same set of facts were presented today it would be handled differently? The reason I raise that is I just came from a panel discussion over at the Georgetown Law Center with Senator Sarbanes. He made an excellent point in terms of what we describe as structural changes in the corporate structure to make certain that the Enron and the WorldCom do not happen again. Obviously, some of these things like we are talking about today, we talk about after the fact. The damage has already been done.

The goal, of course, was to provide necessary internal controls in the law so that this would be detected early on. From your perspective, what has Fannie done to provide the kind of internal controls, checks and balances necessary in the future?

Mr. SMITH. As a result of Sarbanes-Oxley 404, we have developed and implemented a formal company-wide anti-fraud policy that requires that any employee who suspects fraud or wrongdoing report that fraud up through appropriate channels. We have certainly all at Fannie Mae, we all have a heightened sense of awareness about all issues pertaining to fraud.

We have centralized lender approvals in our Chicago office to really focus on the lender approval process to ensure that the lenders that we approve have the appropriate capabilities that Fannie Mae would require. We have also centralized our post-purchase loan file reviews in our Dallas office, and we select the files that we want to review with some models we have developed that would prompt Fannie Mae to ask that those files that contain certain risk factors be the files that we request from the lender for review.

We have also created in the Dallas office a fraud team. By having the file reviews in a single office instead of the five offices, it is a little bit easier to spot trends of fraud across many lenders. There could be a real estate professional, an appraiser or a real estate broker that is involved in some improper arrangements, but if that professional or broker is involved with several lenders, each lender only sees a small piece of the arrangement. But by having Fannie Mae's one office look at the file reviews, we can better spot whenever there is a real estate professional or a broker that is feeding to a number of lenders loans that are improper. The fraud team helps us do that.

Mr. OXLEY. You say that is in Dallas?

Mr. SMITH. That is in our Dallas office which we call the National Underwriting Center.

Mr. OXLEY. And how many personnel do you have on that? Obviously, you have some sophisticated software to aid those folks in their endeavors.

Mr. SMITH. I do not know the number. I think the number of people, I am speculating that the number of people in the Dallas National Underwriting Center could be 150 to 200 total. This fraud team I am speaking about has a director and a staff of several. I do not specifically know the number.

Mr. OXLEY. And they have the necessary technology to be able to follow those leads?

Mr. SMITH. They investigate issues and do whatever they need to do.

Mr. OXLEY. What is the role of modern technology? Are these just basically gumshoes that follow the paper trail? Or do they have a sophisticated computerized operation?

Mr. SMITH. I really do not know. I am not involved in that operation. I really do not know.

Mr. OXLEY. Okay. Thank you.

Thank you, Madam Chairman.

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Cleaver?

Mr. CLEAVER. Thank you, Madam Chair.

Either Mr. Donohue or Mr. Kennedy, we deal with this in every aspect of government and life now, and I want to bring it to you in the same way we deal with it in other arenas. It appears as if more and more cases of fraud are uncovered every year. The question is, is that due to the fact that we have a much better, far more sophisticated system of detection? Or are we simply having more and more fraud, and that it is significantly higher than it was in previous years? I mean, how many cases of fraud does Ginnie Mae encounter each year, or Fannie Mae for that matter?

Mr. DONOHUE. That is a very good question, sir. I think the answer to that is both. I think what I have seen is in different areas, the queue seems to be, as the cooperation and the reporting from these GSEs or the regulatory departments to the respective appropriate federal law enforcement agencies address these issues. So I think the first answer is I think better cooperation, communications, we are getting more cases we might not have seen in the past.

I will comment to you, however. I have spoken to outside counsel of various banking institutions. One of the things they tell me is this. They tell me that often in the industry that at times the industry is reluctant to pass this information on, on criminal matters and on civil litigation, because of the costs involved and so on. Cases involving bad publicity can come out of these matters.

What I try to do and encourage upon them is to try and make sure they pass that information on because my graves concern, as I found out when I was at the RTC, is the very people that perpetrate these crimes go on to another one and go on to another one and go on to another one. So I think that is the benchmark with regard to it.

Do I think there is better reporting? Yes, I do. Do I think coordination is better? Yes, I do. And we have our own task. We work very closely with the FBI and ourselves in doing many of these cases as well. I, as you well know, my jurisdiction rests with the FHA and Ginnie Mae and Fannie Mae, unless it has a relationship to it.

Mr. CLEAVER. What happens if someone makes an accusation that is proven untrue? I mean, if someone, for example, goes out and says I have reason to believe that fraud is taking place here or there, and it is investigated and it is found to be untrue. What happens to that person? Are they liable? Are they going to lose their job? Do they end up in court?

Mr. DONOHUE. The way it comes to us, when it finally comes to us, of course we are looking at the notion about the evidentiary aspect to it. We study the case, look at it, and investigate the case entirely, which is within our full jurisdiction, and present that matter to the U.S. Attorney's office for the outcome. Typically with cases involving us, when the person is found to be, I should say, not prosecuted or declined prosecution, we attempt to notify those people, let them know the fact that the case has been resolved or will not be criminally adjudicated. It then does take a civil component to it. The Federal system has a way to be able to deal with those matters. But I think the question as far as the liability issue needs to be directed to these other folks here.

Mr. KENNEDY. If I may in terms of, from the Ginnie Mae perspective. Clearly, if you look at this case, First Beneficial, there are lessons to be learned from it. Almost immediately, within a matter of days, Ginnie Mae looked at the case and rather than go through a rulemaking process to change their procedures, they instituted immediately a process whereby all issuers were looked at and compared in terms of a profile to see whether or not there were indicators in the files that suggested that an issuer might have problems.

But I think we should be clear about one thing. As soon as Ginnie Mae found out that there were loans in the files for which

there was a piece of vacant property, no house, no mortgagor, we do not tend to characterize that as an irregularity. It was clear to us that given that set of facts, we had a fraud case. I think that at this point Fannie Mae would view that same set of facts the same way. It is not a question of irregularities and the loans are not eligible for the pool. It is a question of these are fictitious mortgages.

I think that clearly Fannie Mae has indicated their desire to raise the expectations, even within their own offices, that can find those kinds of cases. That is not an irregularity. I should say, and I will say it here, that based on Ginnie Mae's immediate change in its procedures, another case was discovered, very similar. Immediate action was taken to suspend their approval as a Ginnie Mae issuer. That was done because they acted quickly based on the facts before them. It is a good example of how it can work and how it should work. Those matters were referred to the IG and to the enforcement folks.

Mrs. KELLY. Thank you very much.

Mr. CLEAVER. Thank you, Madam Chair.

Mrs. KELLY. Mr. Garrett?

Mr. GARRETT. Thank you, Madam Chairman, and thank you, gentlemen for being with us this morning.

As with much of what we do here, as was said, it is appropriate that we examine this, and it is good that the barn door is now being closed after the horse got out. Of course, we are trying to go forward from there.

Let me take a step back and look at the big picture. Fannie Mae obviously exists as different from other financial institutions, and that is because it has a status as a creation of Congress. Because of that, Fannie Mae has special benefits that are not available to other financial institutions, such as having that line of credit from the Department of Treasury, the exemption from state and local corporate income taxes, and the perception that your securities are backed by the Federal Government, and until recently, an exemption from the registration with the SEC.

So the big question that I think people will be asking is, is it in your opinion that you as a responsible corporate citizen with all of these added advantages that you have, with relationship to the Federal Government, that you silence when you discovered a major fraud fell below what is an appropriate conduct for a corporation that has this connection to the Federal Government?

Mr. SMITH. At the time, and we are looking back with 20/20 hindsight, at the time, James McLean, when I confronted him with these irregularities and I explained that the loans sold to Fannie Mae were not eligible for sale to Fannie Mae, that they did not meet our requirements, Mr. McLean stated that the errors were due to poor management and a poor understanding of Fannie Mae's requirements. Given the fact that First Beneficial was such a small lender, it was credible to me that misunderstandings might have occurred and that the misunderstandings might be corrected through additional training for First Beneficial and that the loans sold to Fannie Mae, the ineligible loans, that breach of contract could be cured by James McLean repurchasing the loans from Fannie Mae.



Certainly, when I look back now and with the heightened sense of awareness about all matters pertaining to fraud, I think Fannie Mae clearly could have done a better job in how it handled that situation.

Mr. GARRETT. Mr. Donohue indicated that, from your experience, and you have seen cases of fraud, that the entity does not do it once. They do it, I think you said, over and over and over again in different circumstances. So again back to you, Mr. Smith, in essence do you feel that everything occurred as it did, and you basically got your money back. Was there no obligation then to ensure that First Beneficial would not try to simply push these bad loans off onto some other unsuspecting investor and not to allow the fraud to continue to perpetuate itself as Mr. Donohue indicates is often the track record of these?

Mr. SMITH. It was my belief at the time that the problems were due to a small lender making poor judgments and not understanding Fannie Mae's requirements.

Mr. GARRETT. Okay.

Mr. SMITH. It was only when I got a copy of HUD's termination letter where Ginnie Mae was terminating First Beneficial, that I became aware of the fact that James had even been involved with Ginnie Mae, and it became apparent to me at that time, looking back, that the issues we had uncovered might have been more than simple misunderstandings.

Mr. GARRETT. And you have just said twice now that it was a small lender. In your earlier testimony, I think you said that you were shocked at how small a lender they were and that they were approved to do business with Fannie Mae.

A couple of questions. Have you done an investigation? Have you looked to see whether there are other similarly situated small lenders that shocked you that they are doing business with Fannie Mae? Are there others that you think you need to make a review on going forward? Are there policies in place that you make sure that it does not occur again at inappropriately sized lenders?

I guess it goes to the "also" question. Is any of this driven by the fact that, are any of the occurrences here as far as approving of these lenders, or are any of the facts as far as the miscues, if you will, as far as seeing what was occurring with them, tied to the fact that compensation packages were maybe tied to whether or not we are going to approve these numbers of small lenders, or compensation packages were tied to the fact that these loans would continue to go through?

Mr. SMITH. In my earlier remarks when I spoke about being shocked, what I was referring to was when I got HUD's termination letter I was shocked that a small lender like First Beneficial, who had been selling single loans to Fannie Mae, not selling groups of loans and doing mortgage-backed securities. My shock was that a small lender like First Beneficial could have been doing business with Ginnie Mae.

I am the person at Fannie Mae that actually approved First Beneficial to become a seller-servicer. I knew that he was a small lender, and we at Fannie Mae in fact tried to provide James McLean and First Beneficial with extra training to help them really understand how to do business with Fannie Mae. So if I said earlier, if

I said I was shocked that First Beneficial was Fannie Mae-approved, I meant to say Ginnie Mae.

Mr. GARRETT. Okay.

Mr. SMITH. On the issue of compensation, back in 1998, as best as I can recall, I personally had about 40 goals that I was held accountable for and that would influence my bonus. Only one of those goals in any way in my opinion touched on this kind of an issue. That goal was to hold Fannie Mae's overall credit losses, it was either at the same point or slightly less than the previous year. That was a national goal, not a goal for the Atlanta office or for lenders in North Carolina.

However, looking back on this situation in 1998, the vacant lot loans were discovered in December of 1998, and even if the loans had not been repurchased, Fannie Mae would not have foreclosed on those loans, until sometime in 1999, and we would not have realized any losses, actual losses on those loans until we had sold the real estate and then booked the loss and that probably would have occurred in 1999. During this period of time, none of the decisions I made about First Beneficial were influenced by matters of compensation.

Mr. GARRETT. I see my time has expired. Thank you.

Mrs. KELLY. Thank you, Mr. Garrett.

Mr. Baker?

Mr. BAKER. Thank you, Madam Chair.

I want to go at a couple of underlying principles here as to their being no obligation to report, as a beginning point. The conclusion reached, Mr. Donohue, in your prepared testimony, the last line indicating there needs to be the view that there was a systemic weakness that needs to be addressed, and had there been better communication these problems perhaps would not have occurred. If we go to Fannie Mae's Web page and go to their code of business conduct, we go to page four of the code of business conduct, employees must report any violation of the code or related, it goes on and on.

If we go to page 14 of the code, they must obey the spirit and letter of all laws and regulations in every area in which they do business. We must support commitment to conduct our business with all government officials at the highest ethical standard. The possible consequences of violation of the established code is termination. That is element one. If we go to the D.C. Bar standard for ethical conduct and we look at a lawyer's obligation to report another's questionable conduct to the D.C. Bar, it is very clear and forthright that one attorney conducting enterprise with another must report to the bar on matters of ethical concern.

If we go to the Sarbanes-Oxley act and look at Section 404 requirements, if we go to an executive summary I have gotten off the SEC Web page, must report accurately all financial data. I am skipping over details, just for the sake of mercy. If we go to the requirements to disclose, if there is a material weakness existing at year-end, it must disclose this fact. I would suggest that by December of 1998, someone should have figured out there was a material weakness in the financial review process and made, as required under Section 404, the required disclosures, which were not made.

If I got to the Department of Justice Web page and look at a recent decision relative to the Riggs Bank, and quoting from the Department of Justice finding, "the financial enterprise was obligated to take steps to ensure that its services would not be utilized for illegal purposes," and it goes on.

My point in bringing all these to your attention is there were clear, legal, regulatory, statutory obligations on the part of someone within this enterprise when they knew that their assets, which were fraudulently represented, were to be sold to another governmentally related enterprise. My first question is, when, based on your observations, did officials at Fannie have constructive knowledge of the material facts of the disposition of assets to Ginnie Mae? Prior to closing or after?

Mr. SMITH. During the period of time in 1998, I did not believe that what we were looking at were fraudulent activities.

Mr. BAKER. Let me interrupt and go on to the facts then. As I understand it, First Beneficial offered to repurchase the entire portfolio of \$35 million. That offer was not accepted by Fannie. In December, Fannie then demanded a repurchase of a package of loans valued at \$4.8 million. Somebody had to do due diligence at that point, to sit across the table, look at documents, and make determinations.

It was then subsequent to that determination, 60 days later, in February, the vacant lot transaction to which you refer, an additional repurchase of \$1.7 million of the 17 lots was demanded. Obviously at that point, someone made the determination in Fannie's organization, these are bad things; we have to get them off our books. What really troubles me about the last quarter of 1998 was that was the quarter in which the \$200 million of expenses was deferred into 1999, then repaid as affecting that earnings-per-share target.

Now, it is just a question. I am not making an allegation. Somebody needs to make an examination of these facts, one, to determine when Fannie officials knew, when judgments were made to sell these assets to Ginnie, and did they know prior to the execution of that sale that Ginnie was the recipient. The fact that subsequent to examination by the inspector general, a consent order and agreement was reached for the payment of a fine of \$7.5 million says to me somebody knew something or else we would not have levied a fine of \$7.5 million equal in value to the repurchase value of that portfolio.

But yet to my knowledge, no individual or group of individuals was held personally accountable despite the clear regulatory and statutory obligations leading up to termination of those employees for obviously fraudulent conduct. Is there any explanation?

Mr. SMITH. I was the senior person on the spot at the time, and I did not believe that this was fraudulent activity. I believed that what we had was a small lender that had—

Mr. BAKER. I know it was a small lender that was trying to dupe Fannie Mae. That is obvious, and apparently they succeeded. There were no internal controls at any point in this process which would have led a reasonable man to conclude that there was something to it? Let me go at it a different way. Why did you reject the \$35

million repurchase offer and simply select the handful of what now appears to be fraudulent transactions to rescind?

Mr. SMITH. Our research had revealed that the entire portfolio was not a bad portfolio.

Mr. BAKER. Yes, your research. That means somebody looked at it, and made an examination. You went document-by-document, loan-by-loan. That was knowledge. Somebody made a business decision, and you made the business decision to dump the fraudulent stuff on somebody else.

Mr. SMITH. Fannie Mae as a general practice relies on warranties made to Fannie Mae by sellers of loans to Fannie Mae.

Mr. BAKER. I understand that. When you have a bulk and you have thousands of transactions, you cannot sit down every day and look at every one of them, but when you have constructive knowledge there is something wrong and you sit down and do the examination and you refuse a \$35 million offer to dump the whole portfolio, and selectively, selectively pick about \$7 million in transactions to rescind, there is your problem. Somebody had knowledge. Somebody made a business decision. Somebody decided we have to get rid of these. And it also, as an ancillary effect, impacted the bonus calculations and the earnings-per-share target for 1998.

I have been way over time. I am sorry, Madam Chairman.

Mrs. KELLY. Thank you very much, Mr. Baker.

I do not think we have completed our inquiry right now, gentlemen, and I am going to initiate a second round of questions here.

I have a question I would like to go back to, Mr. Smith, because I really did not get a clear answer from you. I would like to know, Mr. Baker, Mr. Ney and I sent a letter to Fannie in December of 2004, and I am going to repeat this question. We asked if Fannie Mae was aware of any other instances where an entity of the Federal Government was sold fraudulent loans held at one time by the enterprise. In its respond, Fannie Mae exempted loans that it assigned to the Federal Government in connection with insurance claims. I want to understand that. So will you answer me about why that was exempted in your response to our letter to you.

Mr. SMITH. I believe Fannie Mae's interpretation of your inquiry, especially as it pertained to First Beneficial, was targeted to the sale of loans back to First Beneficial or others, that might have been sold elsewhere. With First Beneficial, the Title I loans turned out not to be Title I loans at all, that there was never any insurance on the Title I loans. They were never loans that could have had a claim paid, and in fact Fannie Mae never received any claim payments on the Title I First Beneficial loans.

Mrs. KELLY. Mr. Baker, would you like to jump in here?

Mr. BAKER. I thought you would never ask. Thank you, Madam Chair.

I am going to go back to Mr. Donohue and the findings reached in your testimony as to enhanced communication would have resolved this problem. Do you believe that there was not an intentional decision, business decision made by executives at Fannie to dispose of these troubled assets? How do we come to the conclusion that if we had all gotten around the table and talked we would have not had this circumstance?

Mr. DONOHUE. Sir, I am an investigator by my experience, and having listened to what you said carefully, I use the word "preponderance." It appears to me in my mind, looking at all the factors involved here, the fact being of a construction loan, the fact that at one point reference to Mr. Smith's comments, he indicated that they were denied access to First Beneficial to be able to review the files that they were investigating. There are a host of matters that come to mind here that tells me that it is reasonable for me to say that something was wrong, as indicated. And I think I have stated to that effect.

Mr. BAKER. Is the matter closed as far as you are concerned? I know Fannie wants to look forward, and we are not going to do this again, but are the facts relating to these transactions from your perspective a closed matter?

Mr. DONOHUE. We consider it at this point a closed case, sir.

Mr. BAKER. Well, I can only express regret, and believe me, I have not had a lot of time to do this. I have only spent maybe the last day looking at the facts. I have come to a very troubled conclusion about what really transpired in moving these assets off Fannie's books to Ginnie Mae's, and the fact that they were as a corporation fined at a corporate level, and there was no personal accountability assigned to anyone is very troubling.

Now, I know Fannie has recently gone through managerial changes and they are perhaps engaging the new folks to direct the ship in a different manner. But in any other enterprise, if this had been publicly reported, somebody would have had some consequences.

Mr. DONOHUE. We worked closely with the U.S. Attorney's office in discussion about the case, but I want to point out as well that I do not have legal authority over Fannie Mae as far as the disposition of what they do. All I can do is work with the U.S. Attorney's office as far as the investigation, and at that point we felt the outcome of the case, the prosecution and the resolution of the forfeiture for this particular matter was addressed.

Mr. BAKER. I certainly understand. You are the fellow who digs up the facts and creates the presentation, and it is up to the U.S. Attorney's office to make judgments about how to proceed. I am not going to say anything about a U.S. Attorney. But I would certainly conclude that resolution in this matter was perhaps not well balanced and that is just my perspective.

I yield back, Madam Chair.

Mrs. KELLY. Reclaiming my time, I would like to ask this board a question. The state was asking for help when it called Fannie Mae. I would like to ask this board what happens now? What kind of a set-up is there available for Fannie Mae or for any entity to respond to a state when they ask for help? We can start with you, Mr. Smith.

Mr. SMITH. If we get a call from a state agency and they claim that fraudulent activity has taken place or is about to take place, then under Fannie Mae's corporate-wide anti-fraud policy, the employee receiving that call would be compelled to report that to the Office of Corporate Justice.

Mrs. KELLY. Excuse me, Mr. Smith. Is that a new policy?

Mr. SMITH. That policy was enacted last year.

Mrs. KELLY. So it is a new policy. It was not in place in 1998.

Mr. SMITH. That is correct.

Mrs. KELLY. And what have you done to inform your employees of that policy?

Mr. SMITH. It is my recollection that when we adopted that policy, an e-mail message was sent to every employee. The policy appeared on Fannie Mae's internal Web site, and managers were asked to be sure that all of their employees read and understood that policy.

Mrs. KELLY. My time is up. I am going to turn now to Mr. Cleaver.

Mr. CLEAVER. Thank you.

I think this question would go to Mr. Pollard, and I am going back to what I raised earlier. My colleague has talked about someone knew or someone possibly knew. The question that I want to deal with really relates more to whistleblowers. I maybe did not ask the question as clearly as I should have the last time. I want to know two things. One, do you think that whistleblowers are inhibited by providing information about some kind of fraudulent transaction because of what may happen to them, particularly if an allegation proves to be untrue? And then secondly, whether or not you think there is a need to amend the Bank Secrecy Act in order to try to provide some protection for GSEs who would give information about some kind of fraudulent transaction?

Mr. POLLARD. Mr. Cleaver, you addressed that to me. I will be happy to answer.

First, we believe there is an obligation to report fraud, known fraud, to government officials at the time it happens. Secondly, and this is where people try and distinguish, is the concern about suspicion of fraud, that I might have a suspicion of fraud and be sued under the Fourth Amendment for liability. I do not want to take off my OFHEO hat, but if I can I will comment a bit on the Bank Secrecy Act.

First, before the Bank Secrecy Act was enacted in 1970, there was an exception called the bank records exception that gave certain comfort to institutions that if they provided information to a government inquiry, they would be protected, particularly if a criminal investigation is involved. That line of cases ended with that sort of statement in the Donaldson case, because the Bank Secrecy Act was passed. In this committee, the Annunzio-Wylie bill added that protection, that safe harbor that parties have mentioned to you, that if you turn in someone on a suspicion and it turns out not to be correct, that you are given a safe harbor. You cannot be sued. Okay?

So I think almost everyone that has commented to the committee has said indeed that the Bank Secrecy Act should be revised to include Fannie and Freddie. But what I would note is that OFHEO in its current actions, and I will put back on that hat, is looking to see what we can do to share information within the parameters of the law that would not raise liability for the enterprise. That is what I mentioned in my testimony that my office is looking into right now. So we are trying to see if the very concerns that are there can be alleviated through practices or procedures by the regulator as opposed to the company.

Mr. CLEAVER. Thank you, Mr. Pollard.  
Thank you, Madam Chair.

Mrs. KELLY. Thank you very much.  
Mr. Baker?

Mr. BAKER. Thank you, Madam Chair.

I just had one quick question to Mr. Pollard, in the light of the Inspector's comments. In your capacity as general counsel for OFHEO, do you view the matters relating to these circumstances now to be a closed case from your perspective?

Mr. POLLARD. No, sir.

Mr. BAKER. Great. And other than the revisions to the Bank Secrecy Act which you have just spoken to, are there other factors in statute which you think should be addressed in the current GSE regulatory reform act?

Mr. POLLARD. Our director has endorsed those legislative changes that you have put in, Mr. Chairman. I think in terms of other matters for us, I have in my written testimony something that goes a little beyond our jurisdiction, but I would simply mention that there may be additional items that will help the U.S. Attorney and the Justice Department. Of course, their expertise is what is important here, not mine.

Right now, the banks have a wide panoply of provisions that facilitate pursuit of those fraudulent parties. I think our goal, as someone said, I forget which, one of the committee members said or someone, is will people just move. There is always going to be fraud, but we need them to move, move out of any enterprises. I believe some of those provisions on Bank Fraud Act Section 311, some of the ones on fraudulent transactions in mortgages that HUD has, for example, that if you engage in fraudulent transactions with them, that is a crime. That would be helpful.

I want to be very cautious, Mr. Chairman. I would say that is sort of my opinion today, that it should be looked into. Your expertise and the Justice Department would be the critical players to me.

Mr. BAKER. I understand, you cannot enforce someone else's rules and regulations, whether it is Section 404 of the SEC Act, if it is the Department of Justice.

Mr. POLLARD. But we can sanction violations of those acts, however, if they occur. We have a proposed rule on corporate governance that will incorporate by reference provisions of the Sarbanes-Oxley law. I was asked why, and I said, to make very clear that once the SEC should determine this type of violation, that we too will have sanctions, and more importantly, we too will seek remedial steps within the enterprise, not merely to sanction them to penalize them. The SEC might do that. We also look to structural changes.

Mr. BAKER. I will formally follow up with a specific set of facts which I hope that your good office will examine and at the appropriate time report back.

Madam Chair, did you wish me to yield to you?

Mrs. KELLY. Mr. Chairman, you are out of time.

Mr. BAKER. Thank you.

Mrs. KELLY. Thank you.

We turn to Ms. Maloney.

Mrs. MALONEY. Thank you.

Mr. POLLARD, I am interested in your proposed rule on mortgage fraud. Can you explain how you plan to handle the information you receive from the GSEs under that proposed rule?

Mr. POLLARD. First, we will be working with them in terms of the actual implementation of the rule, trying to develop both the information systems, the forms, the instructions which are very important in these cases, telling people what you want, and to be candid, what you do not want, letting them know that people's names may have to be taken off at a certain point, ensuring that the information goes to elements of suspicious activities and the information received is in such a manner that may be useful to law enforcement.

So all of that needs to be worked out. I think we are benefited by what has already taken place in the Bank Secrecy Act and with FinCEN, some of the lessons they have learned, the difficulties they have faced. Coming from the banking industry myself, at one point having viewed their side of it, I think we can work with them and with law enforcement to come up with a management of information that will run very smoothly.

Mrs. MALONEY. And how will you coordinate that information with that which you currently receive through the SARs mechanism?

Mr. POLLARD. We will not have a SARs. We will develop our own form. With the help of some of the folks I mentioned before you came in, Ms. Maloney, relating to the law enforcement personnel. We hope to develop a form that will be very useful to everyone, including enterprises in the long run.

What I would note is our rule includes a provision that should another agency, Treasury or someone else, or the Congress passes Bank Secrecy Act reforms that requires another form, OFHEO will look at that form, and if it works we will accept that form.

Mrs. MALONEY. Do you believe that the procedures that Fannie has put in place internally will be more effective in detecting mortgage fraud in the future?

Mr. POLLARD. I would have to tell you that right now that is under our examination staff. We are reviewing them to determine if, first, they have fixed the problems of the past, and second, whether they should be enhanced. So I would not want to give you an answer to that today.

Mrs. MALONEY. Okay. Also, representing OFHEO, given the facts that were available at the time of this investigation with Beneficial, do you believe that Fannie Mae should have concluded that First Beneficial was engaged in deliberate fraud, and should that suspicion have been reported to you?

Mr. POLLARD. I think our major concerns were, in learning of this, was first, what were Fannie Mae's decisions about what constituted fraud or suspicious activities. I have heard a lot about ineligible loans. If you are passing all of your transactions through a sieve of is it ineligible under our standards, and not also passing them through is there suspicious activity, then they may not have considered them suspicious.

In terms of reporting to us, we had a rather informal system of expecting major items to be reported to us. We are still inves-



tigating whether, and as Mr. Smith admitted, the regional office was so isolated and decentralized that they would have not reported to the Washington office, the headquarters, with whom we normally deal. So I guess my answer to your question is we are still investigating to get a solid answer to that.

Mrs. MALONEY. Okay. Who is representing Ginnie Mae? Anybody? Okay.

Did the North Carolina authorities that contacted Fannie also contact you about their concerns?

Mr. KENNEDY. No, not at that time.

Mrs. MALONEY. They did not contact you?

Mr. KENNEDY. Not at the time that the case first was initiated.

Mrs. MALONEY. Okay. And what new procedures have you put in place to prevent the purchase of fraudulent loans, to prevent this happening in the future?

Mr. KENNEDY. Almost immediately after the case was referred to the U.S. Attorney's office in North Carolina, Ginnie Mae instituted an expedited process whereby instead of waiting, the previous policy that required a look at an issue within a year to see whether or not the documents were in the file, Ginnie Mae what we call a profile. The profile looked at each and every Ginnie Mae issuer to determine whether or not that issuer was within the normal ranges. For example, on the issue of mortgage insurance, the normal range is that after a period of time it was roughly 95 percent. Based on that kind of a review, this kind of fraud could not be repeated.

Going back to the question of our involvement with bank examiners, if we ever receive a call that indicates that there is a potential criminal case, all Federal employees are under an obligation, under an executive order that I think was signed in 1990, that requires us to report that information to the investigation authority within HUD, which is the IG. In this case, that was done immediately, literally I think I got a call concerning the matter in New York, and within an hour I walked down to the IG one floor away and reported the information that I had gotten concerning the matter in New York, which had the appearance to me of a potential fraud. Potential, I did not know.

It is not my job to investigate that, but it is my job to report that. That leads to investigations which then permits the agency at the end of the investigation, at the end of the criminal process, to initiate administrative sanctions under existing rules, under a statute passed by this Congress called the mortgagee review board that permits us to discipline lenders who violate the law or who violate the requirements of HUD.

Mrs. KELLY. Thank you very much, Ms. Maloney. Your time is up.

Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Madam Chair.

I have a question for the Inspector General. Just considering the magnitude of fraud that seems to be getting rooted out through various GSEs, hearing this is very disturbing to me. I was curious if you could share with the panel the loss to the American taxpayer in dollars.

Mr. DONOHUE. In regard to this matter, sir?

Mr. DAVIS OF KENTUCKY. Yes.

Mr. DONOHUE. Yes. The stated amount I believe is \$32 million in total losses, calculated by Ginnie Mae in this matter.

Mr. DAVIS OF KENTUCKY. How much of that has actually been recovered?

Mr. DONOHUE. The forfeiture action is \$7.5 million, and a number of forfeiture seizures against the defendants in this case total \$15 million in recovery.

Mr. DAVIS OF KENTUCKY. Do you anticipate more to be recovered?

Mr. DONOHUE. No comment, sir.

Mr. DAVIS OF KENTUCKY. Okay. Thank you.

I yield back.

Mrs. KELLY. Thank you, Mr. Davis.

Mr. POLLARD, in your statement on the very last page of your testimony for us today, you indicate that you were looking at Fannie Mae's operations to examine whether or not they 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, that they did not take effective action to remedy deficiencies that they discovered, or to act in a timely manner to end their relationship with entities.

I would like you to elaborate on what you found if you can go beyond just those words.

Mr. POLLARD. I really have to leave it at that point based on my job and what the examiners do at our agency. What I would tell you is these subjects and some that have been provided to the committee in the letters from Fannie Mae and even in Mr. Smith's statement today, we are trying to go a bit deeper, a bit further in the operational side. For example, one of the things we mentioned today is whether individuals who are in charge of making loans or making business arrangements in this case are also the same ones who are supposed to fix them. In the banking industry, if you make a loan and it does not go well, that is okay, but you have a workout team that takes it up and tries to clean it up and maybe recover some of the money. They have additional obligations.

So if you would bear with me today, I would simply say that I feel our exam, these are the topics that we are looking into, but since that is ongoing and we are interviewing people, I have to leave it at that point today.

Mrs. KELLY. I would hope that you would get back to this committee when you discover an end-point in your investigations.

OFHEO recently entered into an agreement with the Fannie Mae board of directors, and then the board I believe agreed to make significant improvements to the internal controls of the company. Is the activity that has been discussed before the committee this morning representative of the lack of internal controls that OFHEO has found?

Mr. POLLARD. First, I may comment that we have directed the board not only to undertake fixing internal controls, but to get outside help along with whatever help OFHEO will afford in this instance. So while we are looking at it ourselves, they do have additional parties. Our focus was on accounting. It is quite clear that

controls of a general nature may affect what was going on in accounting. So we have, yes, identified all controls. Is this another example, a decentralization, a lack of control, even a lack of support for regional offices, as well as a lack of quality control emblematic of that? Yes, I believe so.

Mrs. KELLY. Does anyone on this panel know, Mr. Smith, Mr. Donohue, Mr. Pollard, Mr. Kennedy, can you tell me whether or not Fannie Mae still is, among its 40 goals as Mr. Smith testified his bonus was tied to, is that still one of the 40 goals of Fannie Mae, making sure that Fannie Mae does well so that they get more money as a bonus?

I will take an answer from anyone.

Mr. POLLARD. I will answer in saying that it is a subject of our investigation, the level, is there a tie. But additionally, if an individual, as I said, is incented to make loans and to work them out, that may have a perverse incentive, without being specific that you should not have bad loans. It simply creates a situation where the two are sort of impossible to untangle. So we will be looking at compensation in this particular matter, and again that is the topic heading that we are following right now.

Mrs. KELLY. Thank you.

Anyone want to add to that?

Mr. SMITH. Well, certainly at Fannie Mae from my aspect, it is an important part of my job to ensure that we properly manage Fannie Mae's credit losses. The repurchase of ineligible loans is just a small piece of that. We also for any loan that goes toward foreclosure, goes seriously delinquent, we put forth great effort to work with the individual homeowner in loss mitigation efforts so that not only does Fannie Mae not have to take over the REO and sell the property and displace the homeowner, but we actively try to find a way to keep the homeowner in the property.

So I would say that in reaction to your question, managing credit losses is a very important part of what Fannie Mae is focused on.

Mrs. KELLY. Okay. I have a question for you, Mr. Kennedy, I am a little curious about. Why was Ginnie Mae purchasing conventional loans? That is not really their normal course of business, is it? How did this happen?

Mr. KENNEDY. No. The loans in question were not viewed by Ginnie Mae as being conventional loans. There were fraudulent certifications in paperwork submitted to Ginnie Mae indicating that the loans were in fact FHA-insured. As I indicated earlier, both the principal in First Beneficial, James McLean, and for example the auditor, they had misled, they had falsified the documents. They had submitted false certification and information to Ginnie Mae. Ginnie Mae was under the impression at that time, based on the information that was available, that they were in fact FHA loans.

When the scheduled audit that Ginnie Mae scheduled with them was commenced in August of 2000, very quickly it became clear that there was a fraudulent situation here and immediate action was taken on the part of Ginnie Mae to correct that and to default the issuer for the very reason that the loans were not in fact FHA-insured. They have to be under the law to be in the Ginnie Mae pool.

Mrs. KELLY. Thank you.

I have one final question for you, Mr. Pollard. With regard to your proposed rule, will Fannie and Freddie be obligated to inform law enforcement agencies or other governmental organizations when fraud is discovered? Or is this just going to be a mere notice? Will there be a rational reason for the law enforcement people to follow up?

Mr. POLLARD. First, the rule does not provide for that. However, we are looking and working through what will be required in the instructions and to whom notice should be provided. First will be providing notice to us. As I mentioned, we are looking at what we can do to smoothly and at the same time afford protections to the enterprises and transfer that information. But we believe that when a fraud has been identified, there should be no inhibition on going to a state, federal, almost anybody you can contact in law enforcement and tell them there is a fraud.

In this area of suspicious activities, that makes it a bit difficult, but again I believe that we will work through to some processes that may make that more doable. That is the best I can tell you at this time.

Mrs. KELLY. I thank you.

I think that what has occurred here this morning has been very interesting. I hope it makes a very clear statement that we in Congress expect the people who are operating government-secured enterprises to have a moral and ethical obligation to the people of the United States not to defraud them and to root out fraud wherever there is a possibility of it. I think it is very clear.

I thank all of you very much for your indulgence, for being here for such a long period of time. This has been an interesting hearing. The Chair notes that some members may have additional questions for the panel. They may wish to submit those questions in writing, so without objection the record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

With that, this hearing is adjourned. Thank you very much.

[Whereupon, at 12:13 p.m., the subcommittee was adjourned.]

# **A P P E N D I X**

March 10, 2005

*Prepared, not delivered*  
Opening Statement

**Chairman Michael G. Oxley**  
**Committee on Financial Services**

**Subcommittee on Oversight and Investigations**

**“Due Diligence in Mortgage Repurchases and Fannie Mae: The First  
Beneficial Mortgage Case”**  
**March 10, 2005**

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Thank you, Chairwoman Kelly, for convening today's oversight hearing to discuss the First Beneficial Mortgage case.

For some time now, this Committee and its Subcommittees have engaged in detailed and extensive examinations of the Fannie Mae and Freddie Mac.

The Oversight and Investigations Subcommittee's exploration of the complex pattern of financial relationships between Fannie Mae, Ginnie Mae and the First Beneficial Mortgage Company of Charlotte, North Carolina, is a helpful contribution to that overall effort.

Fannie Mae and Freddie Mac have enjoyed advantages granted by Congress that are not shared by all in the marketplace. This was done so that they would enhance competition in that market and accelerate the growth of home ownership nationwide.

These unique organizations have had problems along the way, even as they met their stated goals. As a result, this Committee, the Congress as a whole, and the nation witnessed a parade of scandals and sad stories involving Fannie Mae and Freddie Mac over the past few years.

Today, however, we will look at one particularly troubling case, that of First Beneficial Mortgage.

Fannie Mae's management stood by while Ginnie Mae, a true federal agency also in the secondary real estate loan market, absorbed the hit for a relatively marginal Fannie Mae business loss due to the frauds of Fannie-approved First Beneficial.

Fannie employees, although with no explicit requirement to advise Ginnie Mae of First Beneficial's behavior, allowed the fraudulent sales to Ginnie take place.

First Beneficial then used the proceeds to reimburse Fannie, leaving Ginnie holding the bag. The result? The American taxpayer ultimately absorbed this loss.

The good news is that the architects and enablers of the First Beneficial scheme are in Federal prison with hefty sentences, and Fannie and Freddie have established anti-fraud policies to guide their employees. We will ask our witnesses whether those internal changes will do the job.

I am pleased that Mrs. Kelly has brought together four witnesses who can both help us understand what happened and also discuss how we can prevent a repeat of these frauds in the future.

I welcome the HUD Inspector General, the Honorable Kenneth Donohue, Fannie Mae Vice President Samuel Smith, III, Mr. John P. Kennedy, an Associate Attorney General from HUD, here to present the Ginnie Mae perspective, and the Honorable Alfred Pollard, General Counsel of the Office of Federal Housing Enterprise Oversight.

Again, my thanks to Chairwoman Kelly for convening this hearing. Thanks also to our witnesses for their willingness to explore this matter for the record. I look forward to an enlightening discussion.

I yield back the balance of my time.

**Statement of Chairwoman Sue Kelly  
Subcommittee on Oversight and Investigations  
“Due Diligence in Mortgage Repurchases and Fannie Mae: The First Beneficial Case”  
March 10, 2005**

This hearing of the Oversight and Investigations Subcommittee will come to order.

The subcommittee is meeting today to hear testimony about the transfer of non-performing financial instruments between First Beneficial and Ginnie Mae, with the knowledge of Fannie Mae.

This transaction between a GSE, a wholly owned government corporation, and a private lender exposed taxpayers, investors, and homeowners to harm and threatened the transparency and integrity of the financial networks that support homeownership in the United States.

On December 22, 2004, I joined Chairmen Ney and Baker in sending a letter to Fannie Mae requesting an accounting of its behavior in this case. The Office of Federal Housing Enterprise Oversight (OFHEO) is now proposing new rules to require Fannie Mae to report its awareness of fraud and corruption.

It should not take federal regulation to get Fannie Mae, or any other well-run public company, to exercise its responsibility as a corporate citizen to report possible wrongdoing and protect taxpayers.

I am hopeful that this hearing will lead to better institutional controls within Fannie Mae, industry, and the government to prevent fraud and secure the safety of the homeownership system in the United States.



March 10, 2005

**Subcommittee on Housing and Community Opportunity**

**Hearing: Oversight of the Rural Housing Service budget for 2006**

Rep. Katherine Harris' Statement:

Thank you, Mr. Chairman. I wish to express my appreciation for your leadership in scheduling today's hearing to review the Rural Housing Service's programs. I also wish to welcome our distinguished witnesses. I look forward to your testimony regarding how we can continue to assist our precious rural communities.

Rural Florida continues to occupy a very special place in my heart. I grew up in an agricultural community, and I represent central Florida's citrus and ranching heartland -- Hardee and DeSoto counties. This region symbolizes my state's rich heritage, as well as the fragile balance associated with agricultural economies.

Tragically, last year's hurricanes devastated both counties, threatening this delicate equilibrium while battering the morale of the residents, who have demonstrated extraordinary courage and resilience.

I commend Rural Development's exceptional engagement in recovery efforts. Nevertheless, difficult work remains before our communities can become truly whole again. I look forward to working with you to complete that job.

A significant challenge that we confront in connection with this task is small municipalities' dearth of knowledge and resources in addressing critical housing needs. Enhanced technical assistance for these jurisdictions is essential if they are to fully avail themselves of the funds that are available. I hope that we can make this objective a priority.

Thank you, Mr. Chairman.

**OPENING STATEMENT**

**As Submitted by Hon. Debbie Wasserman Schultz (FL-20)**

**Subcommittee on Oversight & Investigations**

*“Due Diligence in Mortgage Repurchases and Fannie Mae:  
the First Beneficial Mortgage Case”*

**Thank you Chairwoman Kelly, Ranking Member Gutierrez and members of the panel.**

**I would like to emphasize the concern that many of my colleagues have expressed today. The events that led to this hearing are troubling and should be evaluated, but the purpose of this evaluation – *cannot and should not* – be to dwell on mistakes of the past.**

**We must learn from mistakes and use these lessons to move forward with solutions that – *strengthen* – the institutions making it possible for American families to buy homes of their own. I am particularly concerned that Fannie Mae's mission, which is so important, not be compromised or weakened. Fannie's ability to provide homeownership opportunities must be preserved.**

**I am pleased that Fannie Mae is working with its regulators and this Committee to reorganize and improve information sharing systems. I encourage this Committee to incorporate the lessons learned from the First Beneficial case to detect and combat mortgage fraud. I expect and encourage all relevant stakeholders to continue in a productive dialogue as we move forward.**

**I yield back the balance of my time.**



**TESTIMONY OF THE  
HONORABLE KENNETH M. DONOHUE, SR.  
INSPECTOR GENERAL  
DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**BEFORE THE UNITED STATES  
HOUSE OF REPRESENTATIVES  
SUBCOMMITTEE ON OVERSIGHT  
AND INVESTIGATIONS  
COMMITTEE ON FINANCIAL SERVICES  
MARCH 10, 2005**

**Testimony of the  
Honorable Kenneth M. Donohue, Sr.  
Inspector General  
U.S. Department of Housing and Urban Development**

**Before the United States  
House of Representatives  
Subcommittee on Oversight and Investigations  
Committee on Financial Services  
March 10, 2005**

Madame Chairwoman Kelly, Ranking Member Gutierrez, and other members of the Subcommittee, good morning. I am pleased to have this opportunity to bring to the Subcommittee's attention the facts surrounding a recent case developed by the HUD Office of Inspector General and other law enforcement agencies against First Beneficial Mortgage Corporation of Charlotte, North Carolina, and its importance as an area of concern for government sponsored enterprises, regulatory agencies and those that oversee these organizations.

The story of First Beneficial is not simply the story of greed and a major fraud against various victims. The First Beneficial story is also not only a story of earnest detective work and interagency law enforcement cooperation and collaboration, although this case certainly has that element.

**The Players**

By First Beneficial I mean not only the owners but also the corrupt underwriters, accountants and others who made this fraud possible by willingly becoming accomplices to the crime.

Of importance are the crimes of the owners and associates of First Beneficial. But also important is the lack of due diligence by some to take action to mitigate harm against the Government.

For whatever reasons, Fannie Mae (Federal National Mortgage Association) did not pass information on First Beneficial's transgressions to others, which allowed First Beneficial to continue to operate and to issue over \$7.5 million in fraudulent mortgage-backed securities (MBS) guaranteed by Ginnie Mae (Government National Mortgage Association).

Fannie Mae is a private, shareholder-owned company that works to make sure mortgage money is available for lenders. Fannie Mae stock (FNM) is actively traded on the New York Stock Exchange and other exchanges and is part of the Standard & Poor's 500 Composite Stock Price Index. Fannie Mae is a private company operating with private capital on a self-sustaining basis chartered by Congress to direct efforts at increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. Fannie Mae receives no government funding or backing.

Ginnie Mae channels global capital into the nation's housing markets. Specifically, the Ginnie Mae guaranty allows mortgage lenders to obtain a better price for their mortgage loans in the secondary market. The lenders can then use the proceeds to make new mortgage loans available. Ginnie Mae does not buy or sell loans or issue MBS. Ginnie Mae guarantees securities issued by approved issuers. Ginnie Mae guarantees investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans — mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). Ginnie Mae securities are the *only* MBS to carry the full faith and credit guaranty of the United States government.

### **The First Beneficial Crime**

On the easel is a flow chart of the case, which shows in a compressed fashion the timeline of the events I will now discuss. Fannie Mae approved First Beneficial as a single-family mortgage lender in 1995. In 1997, First Beneficial was approved to sell Title I loans. Title I loans are home improvement loans and manufactured housing loans. In 1998 (See timeline exhibit), Fannie Mae was noticing problems with the Title I loan program nationwide and decided to review First Beneficial's loan portfolio. This review uncovered approximately \$1 million in ineligible Title I loans to people without FHA-insured mortgages.

During this review, First Beneficial was not truthful about whether the Title I loans were FHA insured. At this time, Fannie Mae demanded First Beneficial repurchase the portfolio but First Beneficial did not have the funds to repurchase. Fannie Mae worked out a deal where they would purchase new pre-approved single-family loans from First Beneficial and apply the proceeds from the sale of these loans to repurchase the ineligible Title I loans. Fannie Mae placed an in-house suspension on First Beneficial at this time.

After a few weeks, First Beneficial called Fannie Mae and said they had an investor who was willing to buy the bad Title I loans with a single cash payment. Accordingly, in September of 1998 First Beneficial paid Fannie Mae back the nearly \$1 million. First Beneficial did not disclose the source of the funds, nor did Fannie Mae demand an answer.

At this point in 1998 (See timeline exhibit), Fannie Mae did become suspicious of First Beneficial's single-family loans as well and began an inquiry into those it had purchased. They found that many loans were in the names of First Beneficial's owners and employees and that should have caused Fannie Mae concern. First Beneficial said that the loans were 'investor' loans and that they would repurchase them.

On November 3, 1998, Fannie Mae wrote First Beneficial and said they would not purchase any more of their loans without prior approval.

On November 19, 1998, Fannie Mae received a telephone call from a financial crimes investigator with the North Carolina Banking Commission who told them that First Beneficial was making loans without insurance and that First Beneficial was trying to get Ginnie Mae to buy the loans. The investigator gave Fannie Mae the names of two First Beneficial employees, who confirmed their effort to sell loans to Ginnie Mae.

Fannie Mae learned that First Beneficial had only two investor sources -- Fannie Mae and Ginnie Mae.

On November 20, 1998, Fannie Mae suspended First Beneficial as a lender and called in the owner for a meeting. At this meeting, Fannie allegedly wanted to know more about the investors but received no response from First Beneficial. Following this meeting, Fannie Mae did some review by taking the addresses of properties in the loan portfolio and going out to inspect.

What they discovered was that many of the properties listed were, in fact, vacant lots. A check at the courthouse revealed that the named borrowers did not own the properties and that some were not even owned by First Beneficial.

At this point, it is my understanding; Fannie was not under any legal obligation to notify Ginnie Mae, OFHEO, or any law enforcement agency

such as the OIG or FBI. However, I believe that a good corporate citizen should have done so.

Fannie Mae had some knowledge that many of the loans were secured by non-existent houses on land that was not owned by the borrowers. Fannie Mae allowed First Beneficial to repurchase their ineligible loans using the proceeds of a sale to another unwitting purchaser.

In late 2000, Ginnie Mae discovered these transactions through a subsequent compliance audit. Because Fannie Mae did not tell Ginnie Mae the dubious scruples of this lender, the original fraud to Fannie Mae ballooned in costs to Ginnie Mae. By the time it was all said and done, the American taxpayer was defrauded out of approximately \$38 million.

Essential to the scheme was the requirement that First Beneficial provide a mortgage document to the Ginnie Mae document custodian. As you can see from the exhibit on the easel for property listed as "9108 Pleasant Ridge, Charlotte, N.C.," this appears to be at first glance a normal mortgage note. In reality, there was no such mortgage and the signature belongs to a relative of the owner of First Beneficial. The collateral listed on the note was a vacant lot (See picture exhibit) not owned by the stated mortgagor. This is one example of numerous false mortgages created by First Beneficial and backing MBS through the Ginnie Mae program.

Four defendants have been convicted and sentenced. I am happy to report that the ringleader James McLean received one of the largest white-collar sentences in U.S. history. Defendant McLean was sentenced to 21 years in prison and \$23.5 million in restitution was ordered.

In December 2004, a Consent Order was filed providing that Fannie Mae pay \$7,500,000 to the Government as part of ill-gotten gains generated through First Beneficial's criminal activities. An additional 200 individual victims associated with First Beneficial fraud have been, or soon, will be paid restitution in full from assets seized in the case.

Some might say this case is about a small amount or could be interpreted as the cost of doing business particularly as it relates to the vast funds in the securities markets. But you can see from the severe sentence, that the Court viewed this case as a serious matter. The full faith and credit of the United States stands behind Ginnie Mae and it is the integrity of the program that

investors rely upon. The First Beneficial case impacts on the integrity and, if allowed to happen again, wears away at the faith that investors put into this program. No rule or regulation or law existed that made it incumbent on Fannie Mae to have told others what they discovered. But if they had, it may have saved taxpayers millions of dollars.

**Types of Mortgage Fraud of Concern to the HUD/OIG**

While the centerpiece of this case involves false statements and the creation of fictitious mortgages, we in the HUD/OIG are concerned with a multitude of unlawful and deceptive practices and outright frauds in mortgage lending particularly those that exploit FHA borrowers. As we testified last fall before this Committee, some of these practices include:

- Appraisers valuing properties for much more than they are worth.
- Loan officers falsifying income and credit documents.
- Lenders charging fees for services not provided or unnecessary.
- Realtors deceiving the potential homebuyer of the property condition.
- Borrowers duped into re-financing their mortgages over and over until the equity is completely stripped from the property.
- Using stolen or purchased social security numbers and/or credit histories.

Of particular concern is the illegal profiteering on the purchase and quick resale of homes called “property flipping.” The illegality arises because parties to the transaction (seller, loan officer, appraiser) conspire to inflate the value of the home and then pocket the excessive profits at loan closing.

Another concern is “equity skimming.” A common form involves an investor who exploits a homeowner facing foreclosure and financial stress. How is this done?

- Investor offers to resolve the financial problems if the homeowner gives up ownership or an ownership share in the property.
- Homeowner agrees to pay rent to the investor and the investor promises to make the mortgage payments.
- Investor pockets the rent and makes no mortgage payments.
- Lender forecloses on the homeowner (investor’s ownership interest not recorded).



- Investor uses bankruptcy laws to stay foreclosure.

### **Conclusion**

For six years I worked as an Assistant Director for Investigations with the Resolution Trust Corporation to resolve the Savings and Loans failures. One of the few positive things to arise from that financial collapse was that regulatory agencies, the Department of Justice, the Department of Treasury and others began coordinating their information about economic information in the form of a Suspicious Activity Report, created a National Bank Fraud Working Group, and instituted a practice of a continuing dialogue and communication among organizations with like interests.

This effort was designed to try to forestall or to prevent such a destructive event from occurring again. Through cooperation and self-reporting of problems confidence in the marketplace is fostered. I have spoken to outside counsels who have reported to me that too often mortgage lender problems are not referred to the appropriate investigative, audit or regulatory organization for correction or civil litigation. A major lesson learned here, and one that highlights a systemic weakness that needs to be addressed, is that had better communication existed between Fannie Mae and Ginnie Mae, the American people might not have incurred such a loss.

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The HUD Office of Inspector General is charged with locating system weaknesses and recommending either legislative or administrative corrections to promote efficiency and economy in HUD and related programs. I hope we have highlighted an area where action and responsibility needs to be taken.

In closing, I offer my thanks to the Departments of Justice and Treasury and to the IRS Criminal Investigations Division for its help and support in developing this important case.

**WRITTEN STATEMENT OF  
JOHN P. KENNEDY  
U.S. DEPARTMENT OF HOUSING AND URBAN  
DEVELOPMENT**



**BEFORE THE  
UNITED STATES HOUSE OF REPRESENTATIVES  
COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON OVERSIGHT AND  
INVESTIGATIONS  
MARCH 10, 2005**

WRITTEN STATEMENT OF  
JOHN P. KENNEDY  
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Chairwoman Kelly, Ranking Member Gutierrez, and Distinguished Members of the Committee, I am John P. Kennedy, Associate General Counsel for Finance and Regulatory Compliance at the Department of Housing and Urban Development and Senior Counsel for the Government National Mortgage Association (Ginnie Mae). On September 11, 2000, staff from my office accompanied a Ginnie Mae default team to Charlotte, NC to enforce Ginnie Mae's rights under its contractual agreement with First Beneficial Mortgage Corporation, a Ginnie Mae issuer.

My office had contacted the United States Attorney's office to let them know of the civil enforcement action and to request assistance from the U.S. Marshalls during the enforcement process. Shortly after arriving in Charlotte, HUD learned that 37 of 42 properties inspected as part of a Ginnie Mae compliance audit were vacant lots.

It became apparent to my office and the United States Attorney that this was a criminal case and not a routine contractual enforcement matter. My office then assisted in the preparation of an application for a search and seizure warrant for the First Beneficial business offices. Ginnie Mae delayed delivering the default letter to First Beneficial until the search and seizure warrant could be obtained.

On September 14, 2000, the search and seizure warrants were executed by the FBI and files and information were taken from the First Beneficial headquarters. Ginnie Mae delivered its letter extinguishing First Beneficial's right to participate in the Ginnie Mae program and seized all mortgage servicing files and data related to the mortgages backing the Ginnie Mae securities.

We also prepared documents to seize the assets of First Beneficial and its principals. The U.S. government ultimately seized over 100 parcels of property, 20 bank accounts, 7 vehicles, a boat, the personal residence of the owners and the corporate headquarters building.

The FBI and HUD's IG conducted an extensive investigation of the activities of First Beneficial and its principals and employees. In May 2002, the principals and five employees were indicted on various charges, including conspiracy, wire fraud, bank fraud, making false statements and entries and money laundering.

The defendants were tried and convicted in November 2002, and were sentenced in December 2003. The two principals were sentenced to 21 years in prison. Prison sentences for the employees ranged from 11 years to 18 months. All were ordered to pay restitution.

On August 26, 2003, the accountant who provided financial statements on First Beneficial, upon which Ginnie Mae relied, was indicted for making false statements to HUD. The accountant claimed to have been a CPA when his certification was suspended and allegedly did not perform certain tests and verifications as he represented. He was recently sentenced to one year in prison under a plea agreement.

After the convictions and sentencing, my office reviewed evidence developed during the investigation and testimony given during the trial. We determined Fannie Mae might be a party from which restitution would be appropriate.

The investigation of the First Beneficial criminal case provided information that First Beneficial sold fraudulent mortgages to Fannie Mae and that Fannie Mae demanded that First Beneficial repurchase the mortgages. Between December 18, 1998 and February 11, 1999, First Beneficial transferred \$6.5 million to a Fannie Mae account at BB&T, from which it was transferred to Fannie Mae's Federal Reserve account in New York. The evidence tended to show that Fannie Mae knew that First Beneficial would obtain the funds to repurchase the fraudulent mortgages by selling the fraudulent mortgages to another purchaser. The fraudulent mortgages were used to back Ginnie Mae guaranteed securities.

Fannie Mae recovered \$6.5 million from the proceeds of First Beneficial's issuance of Ginnie Mae guaranteed securities backed by the fraudulent mortgages. Because Ginnie Mae did not know of First Beneficial's fraudulent conduct, Ginnie Mae continued to guaranty fraudulent securities issued by First Beneficial until 2000 and ultimately suffered \$35 million in losses.

On January 16, 2004, my office met with the Department of Justice to discuss recovery of these funds from Fannie Mae. We discussed a number of remedies including forfeiture, both civil and criminal.

Through a cooperative effort by the Department of Justice and the United States Attorney's office, a case for criminal forfeiture was presented in Charlotte and the forfeiture was ordered. Fannie Mae agreed to forfeit the funds, with interest, the combination of which totaled \$7.5 million, to Ginnie Mae.

Ginnie Mae will also receive proceeds from the various properties seized in 2000. The properties have been valued at \$8 million. Approximately \$300,000 has also been paid from these funds to more than 200 individuals who were defrauded by First Beneficial, which failed to pay mortgage insurance, property taxes and other expenses. Thank you.

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STATEMENT

of

ALFRED M. POLLARD  
GENERAL COUNSEL  
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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.



**Remarks Prepared for Delivery by  
Samuel M. Smith, III  
Vice President of Single Family Operations, Fannie Mae**

**Testimony by Samuel M. Smith, III Before the Subcommittee on Oversight and  
Investigation, House of Representatives (Written Testimony)  
Washington, DC  
March 10, 2005**

**Introduction**

Thank you, Chairwoman Kelly, Ranking Member Gutierrez and Members of the Subcommittee. My name is Sam Smith. I am Vice President of Single Family Operations for Fannie Mae, and I have worked in Fannie Mae's Atlanta, Georgia office since 1973. In my capacity as Vice President, I am currently responsible for the quality and underwriting of loans sold to Fannie Mae by lenders assigned to Fannie Mae's Eastern Business Center.

I welcome this opportunity to speak on mortgage fraud generally and also about issues arising out of the First Beneficial Mortgage Company matter, and I want to thank the Subcommittee for holding this hearing and for inviting me to be here today.

Fannie Mae takes the issue of mortgage fraud very seriously. Mortgage fraud hurts all of us—consumers, lenders, and communities. The economic impact of mortgage fraud on the industry is real and significant. Lenders face increased credit losses due to fraud, for example, in cases involving identity theft and false home price appreciation, lost revenue when there are occupancy misrepresentations by borrowers, and increased costs associated with implementing anti-fraud detection and prevention measures. These added costs may ultimately affect consumers in the form of higher loan costs.

Let me begin with a short summary of the issue of mortgage fraud, as the circumstances surrounding First Beneficial provide an example of only one type of mortgage fraud.

The problem of fraud in the mortgage industry is serious and research indicates that the incidence of mortgage fraud has increased in the last several years. The FBI has announced that it currently has 533 pending mortgage fraud investigations compared with 102 in 2001. As required by money laundering laws, banks filed over 12,000 Suspicious Activity Reports (SARs) in the first nine months of 2004 as compared to just over 4,000 reports in all of 2001.

The types of fraud that we, and our lender partners, see generally fall into two categories:

- **Fraud for house** – the most common type of mortgage fraud -- is motivated by the desire to get a marginal borrower into a house. In such cases, individuals may intentionally falsify income, credit and asset documentation, not disclose secondary financing and/or provide inflated appraisals. In general, it usually results in relatively modest credit losses, but collectively represents a significant business issue for lenders and the secondary market and harms consumers.
- **Fraud for profit** is motivated by a desire of mortgage loan participants to intentionally acquire mortgage loan proceeds, directly or indirectly, for improper personal gain. Fraud for profit schemes often involve inflated values, factual misrepresentations, undisclosed transfers of the property, undisclosed property owners, undisclosed secondary financing and/or false identifications. Fraud for profit often involves collusion among unscrupulous real estate and mortgage practitioners and is generally viewed by lenders as one of the biggest problems facing the mortgage industry.

First Beneficial was a case involving institution level fraud for profit. Although not as common as fraud for house, as a company we have seen other cases of institutional fraud for profit: for example, Fannie Mae is working with law enforcement officials on a large-scale institutional fraud lasting perhaps five years or more. In that case, we believe the lender stole millions of dollars that should have been remitted to Fannie Mae to pay off mortgage loans that had been refinanced.

Looking back upon the First Beneficial case with the benefit of 20/20 hindsight, there is no doubt that there are things we could have done differently. As the case of First Beneficial highlights for us, Fannie Mae can do more to improve its practices on a continual basis to prevent losses from mortgage fraud to the company, its partners and the public.

Fannie Mae is changing its practices to meet the demands of the changing mortgage fraud landscape and enhancing our own internal anti-fraud control measures and providing our lenders with access to fraud detection and prevention tools that will help reduce their risk exposure and the negative economic impacts of fraudulent loans to the industry and to the consumer.

Fannie Mae is working cooperatively with OFHEO on its recently proposed regulation regarding mortgage fraud reporting. We have stated publicly that we will work with Congress, HUD and law enforcement agencies to establish an appropriate process for sharing information. In addition, we are working closely with others in the industry to confront this growing problem, including participating today in the Mortgage Bankers' Association's summit on mortgage fraud. And, we join with others in the industry in supporting legislative enactment, through GSE reform legislation or otherwise, of a requirement for mortgage fraud reporting, including a safe harbor from legal liability for reporters of potential fraud and an appropriate approach for increased information-sharing between government and the industry.

I will now provide the Subcommittee with a brief description of the events surrounding the First Beneficial matter and then provide more detail on some of the anti-fraud initiatives the company has undertaken since 1998 when the First Beneficial fraud first occurred.

### **First Beneficial**

On January 14, 2005, Fannie Mae submitted responses to Congress' questions regarding the First Beneficial matter. We also have submitted a copy of our outside counsel's conclusions after an internal investigation of the First Beneficial matter. We fully cooperated in the post-conviction ancillary forfeiture proceedings in the U.S. District Court in North Carolina that resulted in a Consent Order stating that Fannie Mae was a victim of First Beneficial's fraud and under which Fannie Mae paid the government over six million dollars that the government identified as stemming from First Beneficial's related fraud on Ginnie Mae. As these documents provide extensive detail on the events leading up to and after the conviction of James and Macy McLean, the principals of First Beneficial, I will only briefly summarize these events here.

First Beneficial initially applied to become a Fannie Mae seller/servicer in April 1995. At that time, the regional office assigned to a lender by geographic location managed approval of new lenders. The lender approval process has since been more centralized. In 1995, however, First Beneficial was located in North Carolina, which fell within Fannie Mae's Southeastern Regional Office in Atlanta. As Vice President for Single Family Operations in the Southeastern Region in 1995, I had responsibility for overseeing First Beneficial's application and approval process.

We rejected First Beneficial's application initially due to several deficiencies in its capabilities. As First Beneficial was a minority-owned lender, however, Fannie Mae took steps to bring First Beneficial into a mentoring relationship with an established lender as we did for other lenders in our Minority and Women-Owned Lender (MWOL) initiative. Before a mentoring relationship could be established, First Beneficial had addressed our concerns by hiring experienced staff and otherwise taking steps to address the deficiencies we had identified. We then approved First Beneficial to sell us first mortgage loans beginning in December 1995. The next two years were largely uneventful for the First Beneficial relationship.

In the summer of 1998, however, we noted high delinquency rates for Title I loans in First Beneficial's portfolio. As part of a quality control review, we noted several other problems such as missing documentation and that some of First Beneficial's loans were ineligible for sale to Fannie Mae. To be ineligible does not mean the loans were bad, fraudulent, or otherwise invalid; it simply means they did not qualify for sale to Fannie Mae under our contractual requirements. At that time, the number of ineligible loans involved was finite and we believed that they were the result of relative inexperience on the lender's part, not intentional wrongdoing. As a result, we determined that the best course of action was to exercise Fannie Mae's right to require First Beneficial to

repurchase the ineligible loans, which it did in September 1998. We also required First Beneficial to seek preapproval for any further sales of loans to Fannie Mae.

By the fall of 1998, however, the problems with First Beneficial's portfolio of loans escalated. Fannie Mae learned that some of the properties securing the loans were either vacant lots or were still under construction – thus, those loans were also ineligible for sale to Fannie Mae. First Beneficial at this time claimed that the ineligible sales resulted from a misunderstanding of Fannie Mae's requirements. While we still did not suspect intentional wrongdoing, we were losing confidence in First Beneficial's ability to bring its operation into compliance with our requirements.

In addition, an employee in my office received a call in November 1998 from the North Carolina State Banking Commission. The Commission's investigator stated he was investigating First Beneficial and advised that he would send a package of information on loan files to Fannie Mae. My employee pledged to have the materials reviewed and stated that we would offer assistance once the materials were reviewed. As far as I have been able to determine, the promised information was never received and there was no follow up from the investigator. The North Carolina investigator also stated that First Beneficial was attempting to get Ginnie Mae to buy loans, but did not specify whether these were loans owned by Fannie Mae.

At the investigator's request, the same Fannie Mae employee spoke with two individuals who represented themselves as First Beneficial employees, one of whom was leaving the company. Both described various problems with First Beneficial. Among other things, one of the employees stated that First Beneficial only sold loans to Fannie Mae and Ginnie Mae. The other employee speculated that First Beneficial might be trying to buy loans back from Fannie Mae and sell them to Ginnie Mae. The company received no further information regarding Ginnie Mae's involvement with First Beneficial until November 2000, as discussed below.

In November 1998, we suspended First Beneficial as a qualified lender and forbid it from selling any additional loans to Fannie Mae. While it was not Fannie Mae's practice to require lenders to disclose the source of funds for loan repurchases, I and others in my office asked McLean on several occasions about the source of funds he intended to use for the repurchase of the vacant/construction lots because First Beneficial was a small lender. McLean told Fannie Mae that First Beneficial had found several subprime loan investors that would purchase loans that did not qualify for sale to Fannie Mae. As I was aware of the practices of subprime lenders, this explanation seemed reasonable at the time. We transferred servicing of Fannie Mae's loans to another lender and engaged in loan repurchases of some of First Beneficial's loans over the course of the next 15 months.

In November 2000, we received a copy of a HUD letter to James McLean, dated October 24, 2000, alleging fraud perpetrated on Ginnie Mae. We promptly ceased any further loan repurchases or other business with First Beneficial as a result.

Shortly thereafter, various branches of the federal government investigating First Beneficial and the McLeans contacted us. We cooperated with government requests and provided documents and witnesses to the government in connection with its investigation. Moreover, we provided substantial assistance in the government's successful conviction of James and Macy McLean and their associates in 2003. I personally participated as a witness for the government at their trial, as did two other former members of my staff. The McLeans are both serving jail sentences for their actions.

My court testimony was the last interaction I had on the First Beneficial matter until I became aware of the forfeiture proceeding in the U.S. District Court for North Carolina. On December 8, 2004, the court issued a Consent Order reflecting the agreement between Fannie Mae and the Department of Justice under which Fannie Mae has provided \$7,500,516.08 to the government. This amount includes \$6,522,188.08 that the government identified as coming from First Beneficial's fraud, plus an additional \$978,328 in stipulated interest. Fannie Mae did not wish to retain the funds or benefit from First Beneficial's illegal activities. This amount covered the two wire transfers for First Beneficial's repurchases in December 1998 and February 1999 of the loans it sold Fannie Mae that were either for vacant lots or for homes that were still under construction. First Beneficial obtained those funds for the two wire transfers to Fannie Mae by defrauding Ginnie Mae.

#### **Anti-Fraud Initiatives**

In 1998, when First Beneficial's loan issues arose, loan deficiencies and instances of suspected fraud were handled on a case-by-case basis by the regional office. Since that time, Fannie Mae's antifraud activities have evolved and expanded as instances of mortgage fraud have increased.

Combating fraud is a high priority for Fannie Mae, as set forth in our company's anti-fraud policy. Fannie Mae has established a cross-functional fraud task force to continually review and improve our policies and approaches. As noted above, Fannie Mae is working cooperatively with OFHEO on its recently proposed regulation regarding mortgage fraud reporting and is analyzing the rule and preparing written comments for the rulemaking record. Those comments are due to the agency on March 28, 2005. We have stated publicly that we will work with Congress, HUD and law enforcement agencies to establish an appropriate process for sharing information. Again, Fannie Mae supports recommendations made by the FBI and the Mortgage Bankers' Association to require reporting of fraud, including a legal safe harbor for reporters of suspected mortgage fraud, and increased communication between the government and the industry regarding mortgage fraud.

I want to highlight some of the key components of Fannie Mae's prevention and detection strategy that specifically relate to mortgage fraud.

**Detecting Fraud**

Fannie Mae is chartered by Congress to operate in the secondary mortgage market and to provide liquidity for residential mortgage markets. We do not originate loans - that is done by lenders in the primary market. As lenders originate loans, it is their responsibility to underwrite loans in a prudent manner and make certain the information they rely on in making their underwriting decisions is accurate. If a lender chooses to sell loans to Fannie Mae, the loans must conform to the requirements set forth in our underwriting guidelines. For every loan delivered to our company, lenders contractually represent and warrant that the loans meet our credit, documentation and underwriting standards. Only after a lender delivers loans to Fannie Mae do we select a sample of loans for our underwriting quality control reviews. These reviews enable us to ensure that lenders are meeting our credit standards and also allow us to identify loans that were ineligible for delivery to Fannie Mae. In cases where ineligible loans are identified through our quality control processes, the selling lender is contractually responsible for repurchasing those loans from Fannie Mae. As previously noted, a loan can be ineligible for many reasons yet not involve any potential fraud. The contractual repurchase obligation provides incentive for lenders to implement procedures for quality underwriting and is one of the ways Fannie Mae manages the safety and soundness of its investments and discourages inappropriate loan underwriting of all types.

As a result of changes in technology and in an effort to ensure consistency and leverage resources, the post-closing file review of all loans sold to Fannie Mae has been centralized, replacing the regional case-by-case approach in place at the time of the First Beneficial matter. We now employ a systematic sampling model to select both newly delivered and defaulted loan files for review every month. This includes a random statistical sample from which review results are extrapolated to allow us to analyze the loan quality of the entire loan portfolio. It also includes a large sample of early payment defaults and loans secured by recently foreclosed properties that are in our real-estate-owned inventory. Several additional units within Fannie Mae perform specialized loan reviews and report their results via a centralized quality assurance system.

Fannie Mae has also established an investigations team that is focused on mortgage loan fraud reviews, research and reporting. This team reviews misrepresentation cases that involve patterns, and follows up on tips of potential fraudulent activity provided from within and outside the company. The emphasis of this group's work is investigating institution level fraud for profit schemes. If there appears to be a pattern of misrepresentations with a certain lender, appraiser, originator, or location, the investigations team will attempt to validate the preliminary misrepresentation findings, look for direct contradictions in loan files and attempt to evaluate motivation.

Currently, when Fannie Mae discovers that a lender has sold us a loan that is ineligible, the lender must repurchase the loan pursuant to their contract with Fannie Mae or indemnify us for losses. If we find that a loan is part of a wider pattern of irregular activity, we take further action depending on the specific circumstances. These actions may include requiring the lender to demonstrate that it has taken corrective action



internally, suspending or terminating the lender(s) involved, notifying law enforcement, reporting loan participants to their respective licensing authorities and/or reporting the incident(s) to a cooperative industry database.

As our January 14, 2005 letter to the Subcommittee notes, Fannie Mae has also changed its requirements for approving lenders as seller/servicers and has moved to a more centralized approval process that can, among other things, focus on the needs of smaller lenders in meeting the seller/servicer requirements.

We are also implementing enhancements to our internal operational controls in these areas. These include internal protocols and procedures to further clarify roles, responsibilities and notification requirements on potential fraud matters. These internal protocols will immediately elevate patterns that suggest possible fraud to senior management and then to our legal and compliance offices. These offices will, in turn, review the cases and be responsible for appropriate external notification, consistent with the corporate anti-fraud policy. Finally, we will generate monthly analysis, case tracking and reports for suspected cases of mortgage fraud.

Under both the corporate anti-fraud policy, and the procedures outlined above, the First Beneficial case would have been handled much differently today.

#### **Anti-Fraud Tools and Technologies**

Fannie Mae is undertaking extensive efforts to assist our lenders in detecting and combating mortgage fraud by developing and encouraging the use of fraud detection tools. Effective fraud detection and prevention requires broad availability and use by lenders of automated fraud detection tools at the earliest phase of the loan origination process – the point of sale. We have devoted a research team to integrate fraud detection tools into our automated-underwriting system, Desktop Underwriter. These tools shift the quality assurance emphasis from the back-end of the loan origination process (post-closing reviews) to the front-end (pre-funding reviews). They provide notifications to the lender that are actionable at the time potential fraud is first detected – before the loan is approved, closed and sold to Fannie Mae. Examples of these tools include notifications to the lender when our internal information indicates that a Social Security Number is invalid and/or when the appraised value of the secured property appears to be inflated.

These initiatives are directed at our efforts to assist lenders in reducing the volume of mortgage fraud occurring in the primary mortgage market and the resulting losses to the lender, investors and the public.

#### **Conclusion**

I look forward to responding to your questions on these matters.