

## New requirement for Fannie and Freddie may mean suspicious activity reporting for mortgage lenders

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Independent mortgage lenders have so far avoided direct responsibility for compliance with the anti-money laundering requirements imposed by the **USA PATRIOT Act**, but this may be changing. On July 28, 2005, the **Office of Federal Housing Enterprise Oversight** issued a final rule requiring **Fannie Mae** and **Freddie Mac** (collectively the "GSEs") to report known or suspected mortgage fraud. The rule, which became effective on Aug. 29, 2005, creates a requirement that the GSEs report instances of mortgage fraud to OFHEO. To be able to comply with this requirement — and with OFHEO's guidance regarding this requirement — the GSEs may have to require the lenders with whom they do business to report suspicious activities of which they become aware.

### The reasons to report fraud

OFHEO's reasons for promulgating the rule include protecting both GSE safety and soundness, and the integrity of the U.S. financial system as a whole.

In proposing its new rule, OFHEO gave two primary motivations for promulgating its new rule. Its first, and apparently principal, motivation was to ensure the ongoing safety and soundness of the GSEs. By instituting a fraud reporting requirement, OFHEO hopes to deter and, if necessary, detect and remedy instances of mortgage fraud perpetrated against the GSEs.

OFHEO explained that its concern regarding fraud against the GSEs was heightened by the recent fraud against Fannie Mae and Ginnie Mae perpetrated by insiders of **First Beneficial Mortgage Corp.** The fraud began by FBMC selling fraudulent mortgage loans to Fannie Mae. Once Fannie Mae discovered that the loans were fraudulent, it required FBMC to repurchase the loans. In order to raise the money necessary to repurchase the loans from Fannie Mae — and apparently having decided that defrauding one government entity was not enough — FBMC sold fraudulent mortgages to Ginnie Mae. Ginnie Mae was not aware, and had not been notified by Fannie Mae, that FBMC had made fraudulent mortgage loans. OFHEO notes that, as a result of failing to report FBMC's fraudulent activities, Fannie Mae agreed to a consent order to pay \$7.5 million to the federal government — the amount, plus interest, the FBMC principals obtained through the fraudulent transactions.

OFHEO's understanding of the need for the rule did not stop at the need to protect the GSEs, however. OFHEO noted in the supplementary material to the proposed rule that it "is aware of the impact of mortgage fraud, not only with respect to the Enterprises, but with respect to the mortgage market as a whole." And while protecting the GSEs from a recurrence of fraud like that carried out by FBMC was a major concern for OFHEO, the

agency also expressed the need to deter, detect and remedy fraud in the mortgage industry generally. OFHEO noted that several lawsuits against mortgage lenders had uncovered examples of allegedly fraudulent appraisals. OFHEO also cited an **FBI** report that complaints of mortgage fraud rose from over 5,600 in FY 2002 to over 12,100 in FY 2003. OFHEO's repeated references to instances of mortgage fraud at other levels of the industry suggest strongly that, while OFHEO's primary motivation for the rule may have been the safety and soundness of the GSEs, that was not its only motivation.

In promulgating the final rule, OFHEO has continued to express concern for fraud in the market generally. OFHEO has quoted an FBI report explaining that a significant part of the mortgage industry does not report mortgage fraud, and that fraud in the secondary market is often underreported. In the absence of reporting, the true level of fraud in the mortgage industry is unknown but is believed to be growing. While OFHEO acknowledges that it does not have authority to police the mortgage industry, it notes that GSEs can exert significant influence on the way the market operates. OFHEO explains that the GSEs, "as part of the financial system, should operate in a manner to deter fraud and thereby assist in system-wide efforts to make mortgage fraud an unattractive avenue for corrupt individuals or institutions." The final rule appears to be an attempt by OFHEO to make the GSEs use their pervasive influence on the mortgage industry to help rid the industry of mortgage fraud.

### The fraud reporting requirements

The new rule, codified in Part 1731 of Title 12 of the Code of Federal Regulations, prohibits the GSEs from either declining to purchase or requiring the repurchase of a mortgage loan, mortgage backed security, or similar instrument because of "possible mortgage fraud" without promptly reporting the fraud to OFHEO. It also requires the GSEs to establish "adequate and efficient internal controls and procedures and an operational training program to assure an effective system to detect and report mortgage fraud or possible mortgage fraud."

These requirements are broad but not detailed. "Mortgage fraud," for example, is defined to include any "material misstatement, misrepresentation, or omission" relied upon by a GSE in determining whether to fund or

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## Guest Commentary

purchase a mortgage, mortgage backed security or similar instrument. The term specifically includes misrepresentations regarding identification or employment documents, mortgagee or mortgagor identity, and appraisals. We can only presume from this list that it includes misrepresentations made by any person, whether or not a party to the mortgage transaction or perhaps even a provider of settlement services, so long as the misrepresentation impinges on the transaction.

Similarly, the GSEs are given little explicit guidance as to the form and content that this prompt report of possible mortgage fraud should take. The report must describe the fraud "in detail," and it must be suitable for sharing with law enforcement, as OFHEO states that it will do with the fraud reports. But OFHEO provides no examples of the data that the report must provide, suggesting that the report needs to explain the possible fraud as much as provide specific items of information.

Finally, OFHEO provides few details on the internal controls and procedures that the GSEs must adopt, although its Policy Guidance regarding Examination for Mortgage Fraud Reporting, issued July 25, 2005, fills in some gaps. In general, it appears that OFEHO is more concerned that the GSEs develop internal controls and procedures that are effective in combating the challenges they face, than that they satisfy an arbitrary checklist of requirements.

### Suspicious activity reporting in all but name?

Banks, thrifts and their respective operating subsidiaries will recognize this as being remarkably similar to the suspicious activity reporting requirement imposed by the **Bank Secrecy Act**. The principal differences are that:

1. Only suspicion of fraud triggers the reporting requirement, rather than suspicion of any violation of federal law or generally suspicious activity, as under the BSA;
2. Reporting is to OFHEO rather than the Treasury Department's Financial Crimes Enforcement Network; and
3. The requirement is not explicitly aimed at combating terrorism and money laundering.

But the combination of a narrative reporting requirement, triggered by a wide range of predicate offenses and backed by stiff sanctions, with an internal control requirement that emphasizes effective risk response rather than use of a compliance checklist, will be familiar to any bank's anti-money laundering officer.

It would be surprising if imposing this requirement on the GSEs did not have an impact on the mortgage lenders with whom the GSEs do business. OFHEO has charged the GSEs with creating internal controls, procedures and training to detect and investigate mortgage fraud. This safety and soundness is threatened not only by fraud committed by the institutions with whom the GSEs transact business, but also by those who attempt to defraud those institutions. One potential, and seemingly natural, response to this fraud risk would be for the GSEs to incorporate in their own controls and procedures a

requirement that those lenders with which the GSE does business adopt controls and procedures in accordance with the GSE's standards. While the form any such standards might take is unclear at present, an obvious source for such standards would be the AML requirements to which many financial institutions are already subject.

The GSEs reasonably could conclude that they can better protect themselves from fraud, and ease their own burden in complying with OFHEO's rule, by requiring mortgage lenders to adopt (if they have not done so already) procedures substantially similar to those necessary for a robust Suspicious Activity Reporting program, if not indeed procedures similar to the whole panoply of AML compliance obligations. For mortgage lenders that are already subject to AML obligations — including banks, thrifts, and their operating subsidiaries — this should impose a relatively small additional burden. For independent mortgage lenders, the need to undertake quasi-SAR activities in order to sell a mortgage loan to a GSE may come as something of a shock. But it is not hard to imagine that the GSEs will impose this obligation on mortgage lenders, whether or not they are experienced in AML compliance.

This appears to be consistent with the larger desires of OFHEO as much as with the narrow regulatory obligations of the GSEs. Given OFHEO's exhortations to the GSEs to take a role in combating mortgage fraud that is consistent with their disproportionate influence on the mortgage industry, it may be that the imposition of a quasi-SAR obligation on mortgage lenders is precisely what OFHEO is hoping for with its fraud reporting rule. Such regulatory engineering is not unprecedented. For example, in recent years the GSEs announced they would no longer purchase mortgage loans containing mandatory arbitration agreements. In justification of this decision, the GSEs explained their actions would benefit consumers generally. The quasi-SAR obligation may simply be another step in the direction of making the GSEs into surrogate regulators for the mortgage marketplace generally. □

### ACORN taps lender as racially predatory

A recent report examining the mortgage lending performance of **Wells Fargo** says that African-Americans and Hispanics on average had been four times and two times respectively more likely than whites to receive high interest rate loans from the nation's second largest mortgage lender.

Based on 2004 **Home Mortgage Disclosure Act** data from 50 states and 50 metropolitan areas, the report, "A Case of *Black and White*," was prepared by the **Association of Community Organizations for Reform Now**.

ACORN said its research showed that one of every eight mortgages made by Wells Fargo to African-Americans in Washington, D.C. were high-rate loans, compared to one out of 227 for whites. For Hispanics in Los Angeles, the numbers were one in every 11 compared to one out of every 61 for whites. □

*For more information see [www.acorn.org](http://www.acorn.org).*