



**Remarks Prepared for Delivery by
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**Testimony by Samuel M. Smith, III Before the Subcommittee on Oversight and
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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.