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BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

HOUSE OF REPRESENTATIVES

June 14, 2004

Thank you, Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee. It is a pleasure to be here today.

My name is Donald J. Bisenius. I am Senior Vice President, Credit Policy and Portfolio Management at Freddie Mac. In this position, I am responsible for establishing and implementing a comprehensive credit risk management framework for Freddie Mac. This includes establishing the standards Freddie Mac uses for determining those institutions from which we will purchase mortgage loans and the terms of those purchases.

I welcome the opportunity to be here today to discuss the steps Freddie Mac has taken in responding to the serious loan origination improprieties and fraudulent activities associated with certain loans made on properties located in the Pocono Mountains of Pennsylvania. Freddie Mac opposes any action that denies homebuyers fair treatment in the purchase of decent, safe and affordable housing.

I commend the Subcommittee for its leadership in promoting responsible lending practices. Congressman Baker has a long history of diligence and vigilance on critical financial services matters.

I would like to recognize Congressman Kanjorski for his tireless dedication to working with affected and concerned parties in developing solutions that will help reduce the likelihood of the situation in the Poconos recurring anywhere in the country. I should go further to note the Congressman's lengthy record of service to affordable housing and economic development in general. I am honored to appear in his district at this important field hearing.

Congressman Baker and Congressman Kanjorski's many years of seniority on the Committee give them a unique vantage point for seasoned, effective public policy advocacy.

Freddie Mac's mission is to ensure a stable supply of low-cost mortgages for America's families – whenever and wherever they need them. For more than 30 years, Freddie Mac has helped meet the home financing needs of families at all income levels, in all communities, and in all parts of the country.

We recognize our special responsibility to homebuyers, the public, the Congress and investors. Freddie Mac is a leader in developing and promoting responsible lending practices and we are a leader in combating mortgage fraud. We have instituted the secondary mortgage market's most comprehensive set of measures designed to protect consumers from predatory lending practices. And, we have a comprehensive quality control program that helps Freddie Mac and lenders combat fraud associated with mortgage lending.

Today, in my comments to this Subcommittee, I will focus on three areas:

- Freddie Mac's extensive credit risk management practices, including our rigorous quality control program that helps us identify loans with suspicious or fraudulent characteristics and helps lenders establish quality control practices that safeguard against fraud;
- The substantial steps Freddie Mac has taken, and continues to follow and enhance, after discovering the fraudulent mortgage activities in the Poconos; and
- Our commitment to the fight against predatory lending practices

Before I turn to these areas, allow me to say a few words about the situation in the Poconos. By some accounts, since the mid-1990s, more than one in five families with mortgages in the Pocono Mountains of Pennsylvania have undergone foreclosure proceedings allegedly attributable to loan origination improprieties and fraud perpetrated by primary market individuals and entities.¹ Numerous allegations of wrongdoing have been leveled against various mortgage originators, servicers, appraisers and others in the real estate community.²

As a company whose mission is to expand affordable homeownership opportunities, Freddie Mac is dedicated to promoting responsible credit underwriting and appraisal practices for all of America's families who seek to achieve the dream of homeownership. Fraudulent mortgage originations have an adverse impact on America's families and the communities in which they live. Our policies, procedures and programs are designed to help Freddie Mac and others in the mortgage finance system better detect fraudulent and suspicious activities. We are committed to working with participants in the mortgage finance system to help prevent fraudulent activities and to help more families realize the full benefits of long-term homeownership.

Freddie Mac's rigorous risk management framework

The prevention, detection and resolution of mortgage fraud and improprieties are an integral part of Freddie Mac's business operations.

Freddie Mac has in place a comprehensive risk management program through which we evaluate rigorously the quality of the mortgage lenders and servicers with whom we do business and the characteristics of the loans we have purchased—whether or not the borrower is making timely payments. Our quality control program helps us identify loans with suspicious or fraudulent characteristics and helps lenders establish quality control practices that safeguard against fraud.

¹ See "Blue Skies and Green Yards, All Lost to Red Ink," New York Times, Section 1, Column 3, Metropolitan Desk, April 11, 2004 and "Hanging On, From Predawn to Way Past Dusk," New York Times, Section B, Column 2, Metropolitan Desk, April 12, 2004.

² See Commonwealth of Pennsylvania v. Percudani, 844 A.2d 35 (Pa. Commw. Ct. 2004).

Before Freddie Mac will purchase mortgage loans from an institution, or allow an institution to service mortgage loans for Freddie Mac, the institution must meet our eligibility requirements.

Our institutional eligibility requirements help ensure that the companies that sell or service mortgage loans for us have the organizational structure, financial resources, quality controls and personnel expertise to originate and service mortgages that are acceptable to Freddie Mac. We perform background reviews of an institution's management by checking records of various regulatory, licensing, and court authorities. In these ways, Freddie Mac seeks to make sure that the management and business practices of the mortgage loan sellers and servicers with whom we do business are sound and reputable.

A Freddie Mac mortgage loan seller or servicer must originate and service mortgages in conformance with the requirements in Freddie Mac's Single-Family Seller/Servicer Guide³ and other contract requirements at all times. Our Guide requires our mortgage loan sellers to operate a quality control program to monitor and evaluate the integrity of their origination processes and to adjust and improve their production processes. We require our mortgage loan sellers to notify us in writing within 30 days anytime the seller determines that a quality control finding affects the eligibility for purchase of a mortgage loan sold to Freddie Mac.

Freddie Mac has a comprehensive framework in place designed to assist us in detecting fraudulent and suspicious activity. We periodically conduct on-site reviews of the operational processes and controls of our mortgage loan sellers and servicers to ensure that their management and business practices continue to meet our high standards. Our operational risk reviews include detailed testing of our mortgage loan seller's broker and correspondent approval and monitoring processes, compliance with prudent underwriting practices, collateral evaluation processes (including appraiser approval and monitoring processes), and quality control programs. These tests and others are designed to ensure that mortgage loan sellers can originate acceptable quality mortgage loans that meet Freddie Mac's standards.

As part of our fraud prevention and detection efforts, Freddie Mac routinely evaluates samples of the mortgage loans we have purchased to check for conformance with contract requirements. We also routinely evaluate samples of those mortgage loans we have purchased that are in default due to nonpayment or that are considered "non-performing" because the borrower is not making timely payments.

³ Freddie Mac requires each mortgage seller to represent and warrant to Freddie Mac that the mortgages they sell to Freddie Mac—whether originated by the seller or by a third party—comply with Freddie Mac's Guide and other contract requirements and were originated in accordance with all applicable laws and regulations.

Freddie Mac evaluates numerous characteristics of these loans to ascertain whether suspicious or fraudulent activity may have occurred. To aid in the discovery of the possibility of inflated property valuations, we also regularly run loans through automated valuation models.

In the event we suspect fraud or discover an irregularity regarding a performing or non-performing mortgage loan, Freddie Mac conducts further investigation to determine the reason for the suspicious characteristic. It is our policy to refer to our internal fraud investigation area all suspicious patterns or trends that might indicate the presence of fraudulent activity.

Freddie Mac has long been a leader in the fight against mortgage fraud. In 1989, we created the first fraud investigation unit in the secondary mortgage market. Our fraud investigation area specializes in conducting intensive investigation of mortgage fraud and works closely with internal and external parties in determining the existence of such fraud.

Freddie Mac has established a toll-free Fraud Hotline for reporting suspected fraudulent activity. We created and maintain an “Exclusionary List” of individuals and companies that have been excluded from participating in transactions involving Freddie Mac loans, either directly or indirectly.⁴

Our team of professional investigators aggressively investigates and pursues individuals and companies who may have committed fraudulent acts. To date, the efforts of our Fraud Unit have led to:

- 464 individuals and 255 companies added to the Freddie Mac Exclusionary List
- Over 100 indictments by federal and state prosecutors
- 76 convictions
- Nearly \$75 million in civil judgments, and \$20 million in criminal restitution orders
- Recovery of nearly 70 percent of all of our fraud losses

Although Freddie Mac’s Fraud Unit is not a law enforcement agency, we refer most of our major cases to the Federal Bureau of Investigation (FBI) and the United States Attorney’s offices. In addition to working with the FBI, we also work with state and local law enforcement agencies. In most of these cases, we have provided substantial assistance and expertise in establishing and addressing the fraud.

⁴ Freddie Mac’s mortgage loan sellers and servicers must warrant to Freddie Mac that no individual or company on the Exclusionary List is involved in the origination or servicing of a loan sold to, or serviced for, Freddie Mac. The Exclusionary List is updated and distributed to mortgage sellers and servicers monthly. Freddie Mac prohibits further distribution of the Exclusionary List to third parties because it contains confidential information.

Freddie Mac promotes fraud awareness and works with others in the industry and in law enforcement on anti-fraud initiatives. We actively participate in industry-wide training seminars and training sessions that focus on fraud prevention. In addition, we actively participate in anti-fraud task forces in several cities across the country (currently Atlanta, Indianapolis, Kansas City, Chicago and Las Vegas). We are also regular participants in the training of new FBI agents at the FBI's headquarters in Quantico, Virginia.

Once we have determined that fraud has occurred, Freddie Mac may take a variety of steps to remedy or resolve the situation, depending on the particular set of facts and circumstances. Among other steps, Freddie Mac may require the mortgage seller to repurchase a loan, terminate our business relationships with the individuals or companies involved, refer the matter to state or local regulators, or refer the matter to federal, state or local authorities for possible criminal or civil action. In all cases, Freddie Mac is fully committed to working closely with criminal and civil authorities toward resolving the matter.

Freddie Mac is also firmly committed to helping participants in the mortgage finance industry establish comprehensive quality control practices that safeguard against fraud and improper business practices. Freddie Mac has developed and makes available to all of its mortgage sellers and servicers information about best practices for quality controls. Our publication entitled, "Discover Gold Through Quality" helps mortgage loan sellers and servicers learn how to develop and maintain a comprehensive quality control program, effectively manage their wholesale operations and prevent and mitigate fraud losses. This publication is available online at www.freddie.mac.com/singlefamily/ and is attached to this testimony.

Freddie Mac's response to the discovery of fraudulent activities in the Poconos

Let me now turn to the substantial steps Freddie Mac has taken, and continues to follow and enhance, after discovering the fraudulent mortgage activities in the Poconos.

Freddie Mac discovered the fraudulent activities related to the Poconos mortgage loans through our quality control program and our fraud investigations area. In addition, we were notified by a lender of the possibility of fraudulent loans in the Poconos with inflated appraisals.

When allegations of significant loan origination improprieties arose, Freddie Mac issued an "Industry Letter" alerting the primary market of serious allegations of fraud in connection with loan originations in the Poconos.⁵ The Industry Letter recommended that primary market lenders exercise due diligence and remain vigilant in establishing and maintaining lending practices that help borrowers achieve affordable homeownership.

⁵ Industry Letter, "Allegations of loan origination improprieties and fraud," distributed to all Freddie Mac Sellers and Servicers, August 20, 2001.

The Industry Letter also emphasized Freddie Mac's strong commitment to helping reduce the likelihood of mortgage fraud in any part of the country and underscored our dedication to pursuing our own investigation of the Poconos loans. I am attaching this Industry Letter to this testimony.

After determining the existence of fraud, Freddie Mac held accountable the primary market participants who were involved. We placed several individuals and companies on our "Exclusionary List" so that they were excluded from participating in transactions involving Freddie Mac loans, either directly or indirectly.⁶ Parties on the Freddie Mac Exclusionary List may not be involved in the origination or servicing of loans sold to Freddie Mac, and Freddie Mac's mortgage loan sellers and servicers must warrant to Freddie Mac that no party on the Exclusionary List is involved in the origination or servicing of a loan sold to, or serviced for, Freddie Mac.

Freddie Mac worked closely with the primary market to facilitate a process whereby the primary market was able to provide many Poconos borrowers with the appropriate assistance and corrective measures that would enable them to keep their homes. Freddie Mac suspended all foreclosure activity on the affected Poconos loans so that the borrowers and the primary market lenders would have sufficient time and opportunity to work through the problems associated with these fraudulent loans. The primary market ultimately adjusted borrowers' loan balances to reflect the fair market value of the properties secured by the loans.

Freddie Mac representatives met with borrowers and their representatives in an effort to help the situation by responding to their questions, addressing their concerns and providing assistance through imparting information. Freddie Mac established a special toll-free Poconos Hotline for responding specifically to Poconos borrowers' questions and concerns.

Throughout the period of investigation and discovery of the fraudulent activities in the Poconos, Freddie Mac worked closely with criminal and civil authorities, providing them with extensive information and expertise in developing criminal and civil cases. Because Freddie Mac was one of the first entities to recognize, investigate and address the Poconos situation, Freddie Mac had a considerable amount of useful knowledge and information.

Internally, Freddie Mac assembled cross-divisional teams that were responsible for responding quickly and appropriately to the situation unfolding in the Poconos. On the basis of our experience with the Poconos situation, we have refined this model and incorporated it into our business operations for responding to potential and emerging fraudulent activities. We have also enhanced our focus on operational risk as demonstrated by our expansion of on-site evaluations of mortgage loan sellers and servicers.

⁶ These individuals and entities were placed on the Exclusionary List after notice and an opportunity to present to Freddie Mac in writing their arguments and facts as to why they should not be placed on the List.

Freddie Mac's commitment to the fight against predatory lending practices

Freddie Mac requires all mortgage loan sellers and servicers to originate and service every mortgage loan they sell to us, or service for us, in conformance with the contract requirements in our Seller/Servicer Guide and other contract requirements and in conformance with all applicable laws and regulations.

Freddie Mac has instituted the secondary mortgage market's most comprehensive set of measures designed to protect consumers from predatory lending practices. These measures include educational campaigns in communities across the country, corporate policies, and targeted mortgage products.

The fraudulent activities that occurred in the Poconos and that have occurred elsewhere in the country serve to reinforce Freddie Mac's unwavering commitment to combating predatory lending practices.

Helping potential borrowers better understand the mortgage lending process is one way to protect borrowers from predatory lending practices. Freddie Mac has expanded the Don't Borrow TroubleSM campaign, pioneered in Boston by Boston Mayor Thomas M. Menino and the Massachusetts Community & Banking Council, to reach more than 30 localities nationwide. Don't Borrow Trouble is the first comprehensive consumer awareness and foreclosure prevention campaign of its kind. Don't Borrow Trouble combines an extensive public education campaign with comprehensive counseling services to help homeowners avoid scams and resolve any financial difficulties they may be experiencing in an informed and prudent manner.

Freddie Mac has also adopted policies that demonstrate our firm commitment to promoting responsible lending practices.

- Mandatory arbitration clauses – Freddie Mac announced in 2003 that, effective August 1, 2004, we would no longer invest in sub-prime mortgages originated on or after that date that contain mandatory arbitration clauses that deny borrowers access to the court system. Freddie Mac is among the first secondary mortgage investors to adopt such a policy.
- Prepayment penalties – Since 2000, Freddie Mac has not purchased mortgages that impose a prepayment premium for a term of more than five years. In March 2002, we announced that we would no longer purchase sub-prime mortgages with a prepayment premium of more than three years. Freddie Mac was the first secondary market financial institution to adopt such a stringent policy on prepayment mortgages.

- High-cost HOEPA loans – Freddie Mac does not purchase high-rate or high-fee loans that are covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA). Freddie Mac was the first secondary market institution to adopt this policy.
- Single premium credit insurance – Freddie Mac does not purchase mortgages containing a prepaid single-premium credit life, credit disability, credit unemployment or credit property insurance policy obtained in connection with the origination of the mortgage, regardless of whether the premium is financed in the mortgage amount or paid from the borrower's funds.
- Credit reporting – Freddie Mac requires all lenders servicing Freddie Mac loans to report monthly borrower mortgage payments to all four major credit repositories. As a result, the repositories will have on file not only negative information about borrowers who fail to make mortgage payments, but also positive information about borrowers who are making timely payments on their mortgages. This may permit borrowers to obtain lower-cost loans as their credit history improves.

In addition to these educational programs and policies promoting responsible lending practices, Freddie Mac is also bringing benefits to borrowers who otherwise might fall victim to predatory lending practices by providing a wider range of mortgage products that make credit less costly and more sustainable. We regularly introduce innovative loan products aimed at giving borrowers with impaired credit greater mortgage choices and initiatives that help borrowers avoid the pitfalls of predatory lending.

Freddie Mac has also taken a leadership role in the development of innovative outreach initiatives designed to provide consumers with information on the use of credit, to make them aware of their financial options and to help them avoid borrowing pitfalls. CreditSmart® and CreditSmart® Español are innovative financial education curricula developed by Freddie Mac in conjunction with several Historically Black Colleges and Universities. These initiatives help consumers understand, build and maintain better credit, thereby preparing them for homeownership and other personal financial goals. CreditSmart® workshops are being provided across the country through our national partnerships.

Conclusion

Freddie Mac has always opposed any action that denies homebuyers fair treatment in the purchase of decent, safe and affordable housing. We have long been a leader in the fight against mortgage fraud. Freddie Mac created the first fraud investigation unit in the secondary market because we are dedicated to helping reduce the likelihood of mortgage fraud.

Our comprehensive risk management framework is designed to help us evaluate the quality of the mortgage lenders and servicers with whom we do business and the characteristics of the loans we have purchased.

After discovering the fraudulent activities in the Poconos, we held accountable the primary market participants who were involved, and we worked closely with the primary market to facilitate a process whereby the primary market was able to provide many Poconos borrowers with the appropriate assistance and corrective measures that would enable them to keep their homes.

Freddie Mac has also instituted the secondary mortgage market's most comprehensive set of measures designed to promote responsible lending practices. Our public education campaigns help potential borrowers better understand the mortgage lending process. We have been among the first secondary mortgage market institutions to adopt anti-predatory lending policies and we have developed a range of mortgage products aimed at making credit less costly and more sustainable.

Thank you for the opportunity to appear today. I look forward to working with you, Congressman Kanjorski, and the members of the Committee, as you consider legislation to help reduce the likelihood of mortgage fraud and predatory lending practices.

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