

Risk in the Home Affordable Modification Program (HAMP)/Financial Disclosures to Law Enforcement

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Topic One: Fraud Risks In HAMP

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Mortgage Asset Research Institute Report (MARI) -- Mortgage Fraud Report (3/09)

Key observations:

- Mortgage fraud today.
- The borrower fraud is concentrated in the loan application:
 - 61% in the loan application
 - 15% in the verifications of employment (VOEs)
 - 10% in the escrow and closing documents
 - 4% in the credit reports
- This is the environment in which the Participating HAMP Loan Servicer is setting foot.
 - Recent GAO survey suggests servicers are unprepared.

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The HAMP Program



Key Program Elements:

- Lender reduces Front End Debt-to-Income (DTI) ratio to 38%
- Treasury matches further reductions down to 31%
- Servicer, Borrower and Lender/Investor Incentives
- High Loan Cap: \$729,750 for single-family dwelling.
 - Even higher for multi-unit dwellings.
- Participating Servicers required to consider all eligible loans
- Borrower must face hardship and default or imminent default

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The HAMP Program (cont'd)



Income and Asset Validation:

- Form 4506-T - Request for Transcript of Tax Return (Mandatory)
 - Submission depends on whether borrower provides tax returns. See Supplemental Directive 09-01.
- Wage earners:
 - Two most recent pay stubs for each wage earner on promissory note.
- For self-employed borrowers or for non-wage income borrowers:
 - *“the borrower’s income will be verified by obtaining other third party documents that provide reasonably reliable evidence of income.”*

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The HAMP Program (cont'd)

Program Expanded in late April:

- Four additional HAMP subprograms, including:
 - Second Lien Modification Program (2MP)
 - Treasury estimates that 50% of “at risk” mortgages have 2nds

Safe Harbor:

- Exposure to claims by investors that the servicer violated the servicing agreement by following the HAMP protocol.
- Applicability of servicer safe harbor where HAMP conflicts with servicing agreement.
- Does the HAMP provide a private right of action?

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The HAMP Program (cont'd)

Monitoring:

- Servicers required to maintain records of key data points for verification/compliance review.
- Servicers required to collect and transmit borrower and property data.
 - Different data sets – Origination and Modification

Anti-Fraud Measures:

- Fraud and false statement exceptions to modification.
 - What leeway exists to forgive past or interim false statements?
 - How do past events impact scrutiny of current representations?
- Servicers should employ reasonable policies and/or procedures to identify fraud in the loan modification process.
- Data collection: Underwriting data will be collected and transmitted to Treasury.

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Servicer Participation Agreement (SPA)

For non-GSE loans, anti-fraud measures include:

- Audit, reporting and data retention requirements.
 - Right to inspect records
 - Servicer will retain and provide to Treasury and Freddie/Fannie loan modification documents
 - Servicer shall take corrective action as Freddie and Fannie direct.
- Internal control program.
 - Includes provision requiring Servicer to develop, enforce and review on a quarterly basis an internal control program designated, among other things, to “effectively monitor and detect loan modification fraud.”

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Delegation of Oversight Responsibilities

Fannie Mae:

- Acts as the Program Administrator.
 - Develops and administers program operations
 - Executes participation agreements
 - Collects data from servicers.

Freddie Mac:

- Acts as the Compliance Agent.
 - Compliance and audit program
 - Information technology testing
 - Security reviews and audits
 - Manages corrective action and reports compliance violations

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The First Concern: Who is the Borrower?



Who is the borrower?

- Borrower may have been sold a limited or no documentation loan product.
 - See GAO-09-837 (Servicers may have limited past data on borrower's income and assets)
- Risk of prior fraud or misrepresentation in original loan application.
 - HAMP does not preclude modification where fraud detected in origination, but what collateral dangers exist for loan servicers?
 - Does the incidental discovery of prior fraud create an obligation to notify third parties, e.g., Investors or law enforcement agencies?
- Incentive for borrower/loan modification consultant to misstate borrower's financial situation may be turned on its head.
 - In loan origination, borrower had incentive to overstate income. In loan modification, borrower may have incentive to understate income.

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The Second Concern: Who is Doing the Modifying?

Do loan modifiers have experience and resources of underwriters?

- Investors and regulators could be concerned that servicing unit:
 - May not have underwriting or fraud detection experience comparable to underwriting or risk management units.
 - May not be staffed to handle high volume of loan modifications.
 - July 9, 2009 Letter from Treasury and HUD
 - May not yet be tightly coordinated with institution's Bank Secrecy Act (BSA) or anti-fraud units or programs.
 - May not apply consistent policies for refusing loan modifications based upon reasonable suspicion of fraud.
 - May tie employee financial incentives to volume of loan modifications.

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The Third Concern: What Are The MHA Anti-Fraud Criteria?

What are the anti-fraud criteria?

- Many of the loan modification applicants will be limited/no document subprime borrowers.
 - HAMP guidance is “reasonable” verification from third-party sources of information. Examples include: certified financial statements, business bank statements, or business tax returns.
- HAMP anti-fraud guidance also emphasizes reasonableness.
 - September 29, 2009 HAMP Update
 - Use good business judgment re: verification documents
 - Not required to modify if: (1) reasonable evidence of fraud; or (2) borrower submitted false or misleading income information.
 - Fraud determination cannot be “*ad hoc*.”
 - It is critical to identify data and data classifications and to have transparent and objective decision-making process.

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The Fourth Concern: Pressure to Modify In Changing Regulatory Environment

Incentives for Speed and Volume

- The HAMP program promotes speed and volume
 - Regulatory pressure to produce high volume of loan modifications increases risk of underwriting mistakes.
 - Difficulty of getting modification documents quickly tends to stratify loan modification decision process.
 - HAMP Updates provide for trial extensions and delayed documentation requirements.
 - Are you tracking and comparing information you receive from the borrower at each phase of loan modification decision?

Changing Regulatory Environment

- See GAO-09-837 (July 2009)
 - Unlike other TARP programs, HAMP is an expenditure (not an investment) program.
 - Treasury is unable to identify, assess and address any potential risks that may prevent servicers from fulfilling program requirements.

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The Legal Risks

Fraud Enforcement and Recovery Act of 2009 (FERA)

- Signed into law on the same day that the President signed the Helping Families Save Their Homes Act of 2009
- Expands definition of “financial institution”
 - Likely collateral consequence is an expanded statute of limitations.
- Funds more prosecutors and agents to investigate and prosecute mortgage fraud
 - \$165 million for each of fiscal years 2010 and 2011.
- What are the consequences for loan servicers?
 - Law enforcement will likely continue to investigate fraud in connection with loan originations for years to come.
 - Loan servicers may receive subpoenas for documents, which may have consequences for loan modification decisions.

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The Legal Risks (Cont'd)

Fraud Enforcement and Recovery Act of 2009 (FERA)

- Expands False Claims Act:
 - Added whistleblower protection, including protection for contractors of servicers
 - Broadens definition of a “claim”
 - Eliminates requirement that contractor intended to secure federal funds
 - Claims submitted to third parties considered a “claim.”
 - Penalties for concealing overpayments
- Creates Financial Crisis Inquiry Commission to investigate causes of financial crisis.
 - Commission has subpoena power and can make law enforcement referrals.
 - Subpoena could ask for internal investigations relating to due diligence of servicer or lender as well as collateral data.

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Loan Modifications Force a “Look Back.”

The Incidental “Look Back”:

- “Servicers should employ reasonable policies and/or procedures to identify fraud in the modification process.”
- What does this mean?
 - Should loan servicers evaluate loan modification documents against other information known to lender or servicer, *e.g.*, Form 1003, prior mortgage fraud suspicious activity reports (SARs), and lists of individuals flagged for bad conduct?
 - Can or should loan servicers use Section 314(b) of USA Patriot Act to request information from loan originator or other financial institutions?
- Should the Servicer sample recent loans to determine if in-depth investigation reveals any problematic pattern of sources of inaccuracy?
- The loan origination documents:
 - Does the Servicer have access to original loan file?
 - Should Servicer digitalize the original loan application (1003)?

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Loan Modifications Force a “Look Back.”

The Incidental “Look Back”:

- Sampling methodology will vary with the kind of fraud events being evaluated.
- Look back can help validate and correct decision tree used to approve modification.
 - Decision tree will provide transparency, defensibility to government, investors, and securities holders.
 - Demonstrate good intent, orderly processes.

HAMP Guidelines:

- Guidelines do not relieve Servicers and Lenders/Investors of accounting and regulatory obligations.
- Redlining and privacy.

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The False Claims Act

The False Claims Act:

- Authorizes private *qui tam* suits in the name of the United States
 - *Qui tam* plaintiff get to share in recovery
 - Treble damages.
 - Penalties per false claim and attorney’s fees.
- FERA expands definition of a “claim” to include claims made to intermediaries between claimant and the government.
 - Modifications submitted to financial agents for the U.S. Treasury would appear to qualify as “claims.”
- Does not require proof of actual intent to defraud.
 - Deliberate ignorance of truth or falsity of information.
 - Reckless disregard of the truth or falsity of information.
 - “Collective Knowledge” doctrine from Bank Secrecy Act/Anti-Money Laundering context.

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Why Be Concerned?

Pressure to modify.

- See July 10, 2009 Wall Street Journal article: Mortgage Firms Prodded to Modify More Loans
- See August 4, 2009 Forbes: Weak Progress on Loan Modifications.
- See September 6 Sacramento Bee article: 480 California cities may yank deposits from institutions that “fail to cooperate with foreclosure prevention efforts.”

Federal Funds are being used in the modifications.

- Servicers make “claims” for federal funds within the meaning of False Claims Act, as amended by FERA.
- SPA specifically references potential False Claims Act liability.
- Government uses False Claims Act in mortgage-related cases.
 - See *Beezer Homes* and *Capmark Finance Inc.*

Topic Two: Financial Privacy and Law Enforcement

RFPA: Limits on Law Enforcement

Right to Financial Privacy Act (RFPA)

- Passed in response to *United States v. Miller*
- Focused on what records the federal government may seek and what disclosures must accompany request.

How May Law Enforcement Lawfully Obtaining Financial Records?

- Consent
 - Customer Right of Access Right to Disclosed Records
- Administrative subpoena or summons
 - Notice provisions (Section 3405)
- A Search warrant
 - Delayed notification (Section 3406)
 - State and local law enforcement

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RFPA: Limits on Law Enforcement (Cont'd)

How May Law Enforcement Lawfully Obtaining Financial Records?

- A judicial subpoena
 - Notification requirements
- A grand jury subpoena
 - *Exempted from notice requirements*
 - *Special non-disclosure rules imposed on financial institutions (Section 3420)*
- SAR Supplemental Documentation
 - *Documentation belongs to Treasury thus not a disclosure*
 - *Do not create records in response to supplemental documentation request*
 - *Do not volunteer information to law enforcement that lies outside of SAR and supplementation documentation*

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Circumventing the RFPA

- SAR Supplemental Documentation
 - Documentation belongs to Treasury thus not a disclosure
 - Do not create records in response to supplemental documentation request
 - Do not volunteer information to law enforcement that lies outside of SAR and supplementation documentation
- National Security Letters
 - NSL process created in 1978 to circumvent RFPA
 - Must be sought for foreign counter intelligence purposes to protect against international terrorism
 - Gag order provisions ruled unconstitutional in *Doe v. Ashcroft* (2008)
 - Obama Administration decided last year not to appeal ruling to Supreme Court

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GLBA: Limits on Financial Institutions

GLBA

- Imposes restraints on what “non-public personal information” a financial institution may disclose.
- Requires notifications when financial institutions share non-public personal information with affiliates and third parties.
- Does not prohibit disclosure if disclosure is authorized by another provision of law, *e.g.*, RFPA.

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Mutual Legal Assistance Treaty Requests

MLATs

- Bi-lateral law enforcement cooperation treaties.
- Appointment of a commissioner
- Disclosure and notification?
 - Does the RFPA apply?

MOUs/Information Sharing

- Agreements made directly between regulatory agencies, e.g., the SEC and its foreign counterpart.
- Certain multi-lateral treaties as well (International Organization of Securities Commissions (IOSCO)).

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Ghidoni Waivers

“Waiver”

- Voluntariness
- Fifth Amendment

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USA Patriot Act

Bank of Nova Scotia Subpoena

- Subpoena served on US branch of foreign bank
- Permission must be obtained from Main Justice

Section 319

- Bank of Nova Scotia decision codified and expanded
- Foreign banks maintaining U.S. correspondent accounts
- Authorizes Attorney General or Secretary of Treasury to issue a subpoena on a foreign bank that maintains a U.S. correspondent account
- U.S. bank must terminate correspondent relationship if foreign bank fails to comply
- Extremely sensitive – potentially adverse impact on foreign relations
- Correspondent bank account seizures

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USA Patriot Act (Cont'd)

Section 314(a)

- Authorizes law enforcement to send out “blast for information” to every financial institution in the U.S.
- Treasury must approve blast.
- Can only be used in money laundering and terrorist investigations

Section 314(b)

- Provides a means for financial institutions to share customer information with one another regarding suspected terrorist or money laundering activities
- GLBA exception

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