

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

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0



## Topic One: Fraud Risks In HAMP

1



## 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.

2



## 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

3



## 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.”*

4



## 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?

5



## 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.

6



## 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.”

7



## 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

8



## 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.

9



## 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.

10



## 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.

11



## 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.

12



## 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.

13



## 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.

14



## 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)?

15



## 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.

16



## 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.

17



## 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

20



## 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*

21



## 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

22



## 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.

23



## 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)).

24



## Ghidoni Waivers

### “Waiver”

- Voluntariness
- Fifth Amendment

25



## 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

26



## 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

27

