

Federal Housing Finance Agency  
Office of Inspector General



**FHFA Should Address the Potential  
Disparity Between the Statutory  
Requirement for Fraud Reporting  
and its Implementing Regulation and  
Advisory Bulletin**

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## Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) face the risk of fraud from various actors in the mortgage market, including originators, counterparties and insiders. Fraud may subject the Enterprises to significant financial, operational, legal, or reputational harm. For this reason, the Enterprises are subject to fraud reporting requirements prescribed by statute, regulation, and guidance issued by the Federal Housing Finance Agency (FHFA).

We undertook this special project to assess FHFA's oversight of the Enterprises' fraud reporting. We found a potential disparity between the fraud reporting requirement in the statute and that in the Agency's regulation and guidance. By statute, an Enterprise must "timely report" to the Agency each occurrence involving the purchase or sale of a loan or financial instrument when the Enterprise discovers fraud or "suspects a possible fraud." The statute also insulates a regulated entity from all liability in connection with making a "good faith" report.

However, FHFA's implementing regulation defines "possible fraud" to require an Enterprise to conduct and complete an inquiry and develop a "reasonable belief" of its existence. The inquiry built into FHFA's definition of "possible fraud" appears to contemplate a higher reporting threshold than the statutory direction to "timely report" a suspicion of possible fraud.

FHFA's implementing regulation requires an Enterprise to report "immediately" fraud and suspicion of possible fraud with significant impact. FHFA's definition of "possible fraud" caused the Enterprises to conduct inquiries that may have delayed reporting of possible fraud with potential significant impact. One Enterprise notified the Agency after conducting a six-week inquiry, and was unable to state when, during its inquiry, it determined that the fraud allegations warranted "immediate" reporting.

We are mindful of the deference to be given an agency's construction of a statute that the agency administers where the statute is ambiguous and the agency's position is reasonable. Given that the fraud reporting requirement is contained in a statute intended to restore confidence in the Enterprises and strengthen regulatory oversight, we question whether an interpretation that appears to weaken the statutory requirement to timely report suspected possible fraud is reasonable.

This report was prepared by Patrice E. Wilson, Senior Investigative Evaluator, and Gregg M. Schwind, Attorney Advisor. We appreciate the cooperation of FHFA staff and Enterprise officials, as well as the assistance of all those who contributed to the preparation of this report.



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This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, [www.fhfaog.gov](http://www.fhfaog.gov).

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## ABBREVIATIONS .....

AB	Advisory Bulletin
DER	Division of Enterprise Regulation
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
HERA	Housing and Economic Recovery Act of 2008
Regulated Entity or Entities	Fannie Mae, Freddie Mac, and the Federal Home Loan Banks
OFHEO	Office of Federal Housing Enterprise Oversight
OIG	Federal Housing Finance Agency Office of Inspector General

## BACKGROUND.....

The Enterprises face the risk of fraud throughout the mortgage life cycle—from origination through loan payoff or property disposition. Fraud may be perpetrated by borrowers, loan originators, mortgage brokers, loan sellers, attorneys, servicers, appraisers, property managers, and insiders. In addition, the Enterprises may be exposed in their capital market activities to fraud committed by counterparties in securitizations. As FHFA has explained, fraud may subject an Enterprise to significant financial, operational, legal, or reputational harm. For those reasons, the Enterprises have long been required to report fraud to the agency that supervises them.

### OFHEO Regulation on Fraud Reporting

Prior to 2008, the Enterprises were supervised by the Office of Federal Housing Enterprise Oversight (OFHEO), which was charged with ensuring the safety and soundness of the Enterprises. Because fraud committed on an Enterprise throughout the mortgage life cycle could adversely affect the safety and soundness of that Enterprise, OFHEO promulgated a fraud reporting requirement in a 2005 regulation. That regulation directed each Enterprise 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 under this part.”<sup>1</sup> It required each Enterprise to “report promptly mortgage fraud or possible mortgage fraud in writing.”<sup>2</sup> That regulation defined both “mortgage fraud” and “possible mortgage fraud.” Mortgage fraud included:

[A] material misstatement, misrepresentation, or omission relied upon by an Enterprise to fund or purchase—or not to fund or purchase—a mortgage, including a mortgage associated with a mortgage-backed security or similar financial instrument issued or guaranteed by an Enterprise. Such mortgage fraud includes, but is not limited to, a material misstatement, misrepresentation, or omission in identification and employment documents, mortgagee or mortgagor identity, and appraisals that are fraudulent.<sup>3</sup>

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<sup>1</sup> 12 C.F.R. § 1731.5 (2005).

<sup>2</sup> *Id.* § 1731.4(a).

<sup>3</sup> *Id.* § 1731.2(c).

Possible mortgage fraud meant that “an Enterprise has a reasonable belief, based upon a review of information available to the Enterprise, that mortgage fraud may be occurring or has occurred.”<sup>4</sup>

## Fraud Reporting Requirements Established by Congress in HERA

In 2008, Congress passed the Housing and Economic Recovery Act of 2008 (HERA). HERA, among other things, created FHFA as the safety, soundness, and housing mission regulator for the Enterprises and the Federal Home Loan Banks (collectively, the regulated entities).<sup>5</sup> HERA requires each regulated entity to establish and maintain procedures designed to discover when it has purchased or sold a fraudulent loan or financial instrument, and mandates that each regulated entity submit “a timely report upon discovery . . . that it has purchased or sold a fraudulent loan or financial instrument, or **suspects a possible fraud** relating to the purchase or sale of any loan or financial instrument.” (Emphasis added.)<sup>6</sup> The next provision insulates a regulated entity from all liability in connection with making a “good faith” report.<sup>7</sup>

## FHFA’s Regulation on Fraud Reporting

In 2010, FHFA promulgated a regulation to implement HERA’s fraud reporting requirements. According to FHFA, effective fraud risk management, including timely fraud reporting to the Agency, is essential to maintain the Enterprises’ safe and sound condition.

FHFA’s regulation, at 12 C.F.R. Part 1233, defines the terms “fraud” for purposes of this reporting requirement. “Fraud” is defined in FHFA’s regulation more broadly than in the OFHEO regulation and means: “a misstatement, misrepresentation, or omission that cannot be corrected and that was relied upon by a regulated entity to purchase or sell a loan or financial instrument.”<sup>8</sup> That definition does not contemplate any inquiry by the regulated entity or level of proof.

In enacting HERA in 2008, Congress crafted a requirement for reporting of possible fraud with a lower threshold than the OFHEO regulation. While the OFHEO regulation required the Enterprises to report “possible fraud,” HERA directed each entity regulated by FHFA to

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<sup>4</sup> *Id.* § 1731.2(e).

<sup>5</sup> HERA also provided FHFA with the authority to place the Enterprises into conservatorships. FHFA exercised that authority in September 2008, and the Enterprises have operated in conservatorship since then. As conservator, the Agency has a parallel duty to preserve and conserve the assets of the Enterprises.

<sup>6</sup> 12 U.S.C. § 4642(a).

<sup>7</sup> *See id.* § 4642(b).

<sup>8</sup> 12 C.F.R. § 1233.2.

report when it “**suspects** a possible fraud” related to a loan or other financial instrument. (Emphasis added.) FHFA’s regulation, however, adopts the same definition of “possible fraud” used by OFHEO:

[A] regulated entity has a **reasonable belief, based upon a review of information available to the regulated entity**, that fraud may be occurring or has occurred. (Emphasis added.)

12 C.F.R. § 1233.2.

That definition appears to contemplate a degree of inquiry and proof beyond the statutory requirement that timely reporting occur when an entity “suspects” a possible fraud.

The regulation also requires immediate reporting to FHFA by a regulated entity when it discovers that it has purchased or sold a fraudulent loan or financial instrument or suspects a possible fraud relating to such purchase or sale, and the fraud or suspected possible fraud “would have a significant impact” on it.

### **FHFA’s 2011 Regulatory Policy Guidance to the Enterprises on Fraud Reporting**

In March 2011, FHFA issued guidance to its regulated entities in connection with its fraud reporting regulation. That guidance directed Fannie Mae and Freddie Mac to file a monthly fraud report on “**all** fraud or possible fraud” and explained that this “additional reporting requirement is due to the business model of Fannie Mae and Freddie Mac as purchasers and guarantors of mortgage loans . . . and reflects the large volume of isolated instances of fraud and possible fraud that Fannie Mae and Freddie Mac may experience.” (Emphasis in original.) It counseled that FHFA would evaluate the extent to which the internal controls of a regulated entity “minimize risks from fraud and the extent to which fraud or possible fraud is consistently reported to FHFA.”

The guidance also directed that immediate reporting of fraud or possible fraud to FHFA within one calendar day is required “when a fraud or possible fraud may involve a significant fiscal, financial or reputational impact on the regulated entity or when a fraud or possible fraud involves insider fraud.” FHFA’s regulatory policy guidance, which was limited to the obligations of the regulated entities to report “fraud” and “possible fraud,” appears to be inconsistent with HERA’s requirement that each entity regulated by FHFA submit a timely report when it discovers “fraud” or “suspects a possible fraud” relating to the purchase or sale of a loan or financial instrument.



## FHFA’s Advisory Bulletin to the Enterprises Providing Guidance on Fraud Reporting

In 2015, FHFA rescinded its regulatory policy guidance, and issued revised guidance to the Enterprises on fraud reporting in Advisory Bulletin 2015-02, Enterprise Fraud Reporting (AB 2015-02).<sup>9</sup> Guidance in AB 2015-02 reprises much of the regulatory policy guidance issued by FHFA in 2011 regarding monthly and quarterly reports of fraud or possible fraud. AB 2015-02 provides additional clarity with respect to the immediate reporting requirement in FHFA’s fraud reporting regulation. It continues the requirement set forth in the rescinded guidance that a report of fraud or possible fraud is required within one calendar day, if the fraud or possible fraud “may have a significant impact on the Enterprise.” It explains further that “[f]raud or possible fraud is considered to have a significant impact if it may create substantial financial or operational risk for the Enterprise, whether from a single event/incident or because it is systemic.” Moreover, “[f]raud or possible fraud is also considered significant if it involves a member of the board of directors, officer, employee, or a contractor temporarily engaged to fill a position or perform a particular function at an Enterprise or other individual similarly engaged by an Enterprise.”

## FACTS AND ANALYSIS .....

### A Potential Disparity Exists Between HERA’s Statutory Requirement for Fraud Reporting and FHFA’s Regulation and AB 2015-02

HERA requires each entity regulated by FHFA to “timely report” to the Agency each occurrence involving a purchase or sale of a loan or financial instrument when it “suspects a possible fraud” and insulates from liability any regulated entity that makes such a report in “good faith.” A reasonable reading of these provisions is that Congress intended the regulated entities to report fraud and suspicions of possible fraud as quickly as possible, and insulated them from liability in the event the reports were not accurate, provided that they were made “in good faith.”

However, FHFA’s implementing regulation defines “possible fraud” as a “reasonable belief, based upon a review of information available to the regulated entity, that fraud may be occurring or has occurred.” The inquiry built into FHFA’s definition of “possible fraud” – gathering proof sufficient to support a “reasonable belief” – appears to contemplate a higher reporting threshold than HERA’s requirement that a regulated entity timely report its suspicions of possible fraud. For example, an Enterprise may suspect that a possible fraud has

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<sup>9</sup> FHFA also issued fraud reporting guidance to the Federal Home Loan Banks in Advisory Bulletin 2015-01, *FHLBank Fraud Reporting*.

occurred or may be occurring but may not have conducted the inquiry and gathered proof sufficient to support a “reasonable belief.” Under FHFA’s regulation, that Enterprise has no obligation to report anything to FHFA until it completes its inquiry, notwithstanding HERA’s direction to report its suspicion.

We are mindful of the deference that federal courts are required to give to an agency’s construction of a statute that the agency administers where the statute is “ambiguous” and the agency’s position is “reasonable.” *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-44 (1984). We also are mindful that one of HERA’s purposes was to restore confidence in the Enterprises—in the midst of a housing finance crisis—by, among other things, strengthening supervisory oversight of the Enterprises and adding authority for FHFA to place them into receivership. In this context, we question whether an interpretation effectively eliminating HERA’s requirement to timely report suspected possible fraud is reasonable.

To understand the basis for the Agency’s definition in its fraud reporting regulation of “possible fraud,” we spoke with the Agency’s General Counsel, who has served in that position since the regulation was promulgated. He did not agree that the Agency’s definition was inconsistent with the statute. In his view, the statutory mandate to each regulated entity to make “a timely report upon discovery . . . that it has purchased or sold a fraudulent loan or financial instrument, or suspects a possible fraud relating to the purchase or sale of any loan or financial instrument” requires the entity to “discover” the suspected fraud. As a result, he explained, an inquiry to gather proof was not only permissible, but necessary, to avoid reporting a large number of “false positives.” The Agency stated that this was a concern raised in discussions with enforcement professionals. However, the Agency’s General Counsel agreed to consider the potential disparity we raised during the Agency’s upcoming review of its regulations.

### **FHFA’s Definition of “Possible Fraud” Caused the Enterprises to Conduct Inquiries that May Have Delayed “Immediate” Reporting of Possible Fraud with Significant Impact**

According to FHFA’s AB 2015-02, an Enterprise must notify FHFA within one calendar day of becoming aware of fraud or possible fraud that may have a significant impact on the Enterprise. Each Enterprise filed one immediate notification during our review period. One Enterprise filed its “immediate” notification three days after its fraud unit received a tip of possible fraud. According to that Enterprise, it spent three days conducting an inquiry into the allegations. The Enterprise was unable to tell us when, during the three-day period, it first suspected that significant potential fraud had occurred.

The other Enterprise received three separate tips over a 16-month period alleging fraudulent mortgages purchased from a top-20 loan seller.<sup>10</sup> It notified FHFA after conducting a six-week inquiry into the last of the three tips. Enterprise officials told us that immediate notification was warranted when the Enterprise determined that all three tips involved the same seller, raising the possibility of institutional fraud.<sup>11</sup> However, these officials were unable to report when, during the six-week inquiry, the Enterprise determined that all three fraud tips involved the same seller. As a consequence, we cannot determine whether the Enterprise’s “immediate notification” was timely (i.e., within one calendar day).

## **FHFA’s Supervisory Activities Examined Compliance with the Agency’s Regulation and AB 2015-02**

FHFA is charged by HERA with, among other things, ensuring that the Enterprises and the Federal Home Loan Banks operate in a safe and sound manner. Within FHFA, the Division of Enterprise Regulation (DER) is responsible for the supervision of the Enterprises. DER has conducted two targeted examinations relating to the Enterprises’ fraud programs since the AB was implemented in March 2015, and ongoing monitoring of the Enterprises’ fraud programs during periods when it did not conduct targeted examinations.

### ***DER Targeted Examinations of Fraud Reporting***

Our review of workpapers for DER’s targeted examinations in 2015 and 2016 found that both examinations focused on the form of the reports the Enterprises submitted, rather than on whether the Enterprises reported all fraud they discovered or suspected.<sup>12</sup>

Those workpapers show that DER examiners verified that both Enterprises used FHFA-approved templates for reporting fraud. Examiners also found that the fraud reports submitted by one Enterprise were timely under AB 2015-02 and that the other Enterprise’s fraud reports were “satisfactory.”<sup>13</sup> DER examiners reported to us, however, that they did not verify the completeness and accuracy of the Enterprises’ fraud reports submitted to FHFA. Review of workpapers for both targeted examinations found no evidence that examiners questioned the difference between HERA’s threshold and FHFA’s regulatory threshold for reporting possible fraud. In our view, the limited scope of these targeted examinations provided no basis to

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<sup>10</sup> The Enterprise received the three tips in July 2014, July 2015, and November 2015.

<sup>11</sup> Enterprise records show that, at the time of notice to FHFA, the Enterprise’s estimated exposure connected to the tips about this top-20 seller was \$298 million.

<sup>12</sup> The DER examinations were of the Enterprises’ fraud programs as well as the Enterprises’ Bank Secrecy Act and anti-money laundering programs.

<sup>13</sup> DER did not examine Enterprise compliance with the immediate notification requirement because neither Enterprise made such a report during the periods covered by the examinations.

determine whether the Enterprises reported all the fraud that they discovered or possible fraud they suspected.

### ***DER Ongoing Monitoring of Fraud Reporting***

Following the completion of its targeted examination of one Enterprise’s fraud program, DER conducted ongoing monitoring of that program during 2016 and 2017. Among other things, this ongoing monitoring consisted of attending fraud-related meetings at the Enterprise and FHFA, monitoring the status of a December 2015 immediate notification of fraud, and reviewing internal fraud reports.

Similarly, DER conducted ongoing monitoring of the other Enterprise’s fraud program in 2015 and 2017. DER reviewed internal monthly and quarterly fraud reports, met with Enterprise fraud personnel, and monitored remediation of the findings from the 2016 targeted examination. DER also monitored a recent reorganization of the Enterprise’s fraud investigation unit and met with Enterprise fraud personnel to discuss the status of a January 2017 immediate notification.

Our review of the workpapers and interviews with examiners led us to conclude that DER did not assess the completeness or accuracy of either Enterprise’s fraud reporting during these ongoing monitoring activities.

## **CONCLUSION.....**

In enacting HERA, Congress intended to strengthen the regulatory framework applicable to the Enterprises. Among other things, HERA requires each Enterprise to “timely report” to FHFA when the Enterprise discovers fraud or suspects possible fraud involving the purchase or sale of a loan or financial instrument. The statute also insulates a regulated entity from all liability in connection with making a “good faith” report.

However, FHFA’s implementing regulation defines “possible fraud” to require an Enterprise to conduct and complete an inquiry prior to reporting suspected fraud. The inquiry built into FHFA’s definition of “possible fraud” appears to contemplate a higher reporting threshold than the statutory direction to “timely report” a suspicion of possible fraud.

We recognize that a federal agency’s reasonable construction of a statute it administers is to be accorded deference where the statute is ambiguous. Given the purposes and plain language of HERA, we question whether a statutory interpretation that appears to weaken the requirement to timely report suspected possible fraud is reasonable.

## OBJECTIVE, SCOPE, AND METHODOLOGY .....

We conducted this special project to assess the effectiveness of FHFA’s oversight in ensuring the Enterprises compliance with AB 2015-02 during the period December 1, 2015, to July 15, 2017. To achieve this objective, we examined the fraud reporting requirements applicable to the Enterprises in AB 2015-02 against the governing statutory and regulatory framework. We reviewed DER’s examination work and interviewed DER and Enterprise personnel.

In addition, we assessed whether the Enterprises notified FHFA within one calendar day of becoming aware of fraud meeting the immediate notification standard in AB 2015-02. We obtained and reviewed the population of two immediate notifications, along with supporting documentation.

This special project was conducted during the period July to October 2017 under the authority of the Inspector General Act of 1978, as amended, and in accordance with the *Quality Standards for Inspection and Evaluation* (January 2012), which were promulgated by the Council of the Inspectors General on Integrity and Efficiency.

We provided a draft of this report to FHFA for its review and comment. The Agency provided technical comments but did not provide a management response. We incorporated the technical comments as appropriate.

## ADDITIONAL INFORMATION AND COPIES.....

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