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Memorandum for the Record with William H. Brewster

William H. Brewster

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MEMORANDUM FOR THE RECORD

Event: Phone interview with **William H. Brewster**, Fannie Mae

Type of Event: Phone interview

Date of Event: Friday, June 11, 2010; 3:00 p.m.

Team Leader: Tom Stanton

Location: 1717 Pennsylvania Avenue, Ste 800, Washington, DC, 20006; small conference room

Participants - Non-Commission:

- **William H. Brewster, "Bill" with Fannie Mae**
- Mike Walsh, counsel, O'Melvaney & Myers
- Miriam Smolen, associate general counsel, Fannie Mae

Participants - Commission:

- Tom Stanton
- Tom Krebs
- Vic Cunicelli
- Jeff Smith
- Tom Borgers
- Karen Dubas

Date of MFR: June 18, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.

STANTON: Can we begin with a bit about your background?

BREWSTER: I'm the director of the Mortgage Fraud program. I've been at Fannie Mae since 1997. Prior to this, I was with Columbia National, where I was in charge of policies and compliance. Part of the quality assurance work that I did there was mortgage fraud investigations. Prior to Columbia National, I was with the Mortgage Bankers Association from 1987-1992. I was responsible for issues advocacy there.

I joined Fannie Mae in 1997 in the underwriting center. I was responsible for managing people who did the underwriting reviews, including fraud investigation work. I was doing that until 2005, when I took on the role of director of the fraud investigation area.

We work closely with the National Underwriting Center to look at underwriting standards and fraud, and we piece together any patterns that we see and report them to our national regulator in a mortgage fraud report, which is like a SAR [Suspicious Activity Report].

STANTON: What has the impact of fraud been on Fannie Mae's business?

BREWSTER: Since 1997, mortgage fraud has been an ongoing concern at Fannie Mae. At a minimum, we put loans back for repurchase when we find fraud. We don't review every loan file—we review a sample. In the underwriting area, they do several different kinds of samples. For a random sample, the mortgage fraud is usually around 1%. In a targeted sample, which might look at loans with a specific attribute like early payment defaults (EPDs), the fraud rate will vary.

The fraud rate has been higher for the past few years. The overall percentage of the fraud has remained less than 1% of Fannie Mae's book of business. We are finding more patterns in the fraud area. The numbers have continued to increase especially for the books of business from between late 2006 and early 2008.

STANTON: To what extent was the increase masked by home price appreciation?

BREWSTER: From our experience, that was certainly one factor. For those loans, if you have home price appreciation, you'd have less foreclosure and fewer loans being reviewed. I think there are other factors as well, including a change in underwriting standards halfway through the decade. People were buying homes that they couldn't afford, and products were being created to accommodate them.

STANTON: Does Fannie Mae buy stated income loans?

BREWSTER: We don't buy them now. I'm not an expert in the credit policy area, but I think there were some purchased previously in the past few years.

STANTON: Was there a kind of loans that had a lot of fraud (2/28s, 3/27s, interest only, stated income)?

BREWSTER: We've found that the product is one factor, but the product is more of an indicator of the type of fraud, not of an increase in the incidence. It's not just related to the product, but also to the lender and the origination climate.

In stated income loans, we saw a lot of cases where people exaggerated. That's different than a document that someone intentionally modified.

KREBS: Do you use third-party due diligence firms to conduct underwriting?

BREWSTER: The National Underwriting Center (NUC) outsources some reviews. NUC is responsible for Fannie's general underwriting reviews.

Desktop Underwriter is a system that lenders use prior to originating and underwriting a loan. The lenders use that to decide whether the loan is eligible to be delivered. It also generates red flag indicators that may suggest that further review is needed. NUC will re-underwrite the loans once they get to Fannie Mae.

STANTON: What factors would go into this? What do you do with the information that you get?

BREWSTER: The sampling models have changed over time. There have been several strata used for sampling—the product type, the lender or originator or counterparty, the credit score or credit profile of the borrowers. These factors change over time, so there hasn't been just one model since 1997.

STANTON: One theory of fraud detection is to focus on a lender who has a substantial increase in volume, especially in a market with negative home price appreciation.

BREWSTER: There's quite a bit of that kind of analysis that goes on. Within the Risk Management area, there's a group that specializes in looking at lenders where there might be a spike in production.

STANTON: Ginnie can drill down and figure out which office of a lender is generating stuff that's unattractive.

BREWSTER: The decision to look at a lender is not automatic. There are meetings and discretion about what criteria needs to be met to do that. Overtime, there's been an improvement in the quality of the data, but it's not as good as the data that the lenders have.

BORGERS: What is the time period you're talking about?

BREWSTER: This is still largely in the 2007-2008 time period in the fraud area. We're also taking a look at delinquencies in more recent originations. We are focusing on it, but that's not where the high volume is.

SMITH: What are the characteristics of the types of fraud that you're seeing now?

BREWSTER: The patterns we see are related to condo projects in areas with higher home price appreciation. We're seeing that sales concessions exceeded underwriting guidelines. Value might be very out of whack with the market. The most common fraud findings are that income is exaggerated and credit is not fully disclosed.

BORGERS: This is fraud for profit as opposed to fraud for housing?

BREWSTER: I don't really accept that division. From an investigative standpoint, the highest volume that drives our investigations is the fraud for house. It obviously generates a profit. I don't know that there's a clear division between the two. It's not necessary for us to make that distinction in an analytical way.

KREBS: Who are the top 5 who you send loans back to?

BREWSTER: Countrywide, Bank of America, Citibank, and Chase. A lot of those lenders were accumulating loans from brokers who distributed them.

I don't know that Countrywide was worse than other people. People were trying to hit the bottom of the box. You can find a loan at the bottom of the credit quality spectrum, but it could be fine and have no other problems.

BORGERS: So once you find that something is fraud, that's all that you care about?

BREWSTER: Yes, but we do try to find patterns. Our regulator requires us to make case reports and loan level reports available.

CUNICELLI: Do you have summaries of those mortgage fraud reports?

BREWSTER: We don't have existing reports like that. We have internal management reports and a quarterly summary report that we write to our regulators.

CUNICELLI: Is this a database system? Could you identify parameters and run reports?

BREWSTER: No, the system does not automatically generate reports. The quality assurance system has specific random reviews, and that's the only report that we could generate.

STANTON: Do they make a distinction between fraud and ______?

BREWSTER: Those are in the credit loss management world. I'd assume that you could get them, but I'm not sure how.

WALSH: It seems like something we would have given you, but we'll check.

BREWSTER: There's a Significant Finding Report by name and product type.

WALSH: We produced disk #5; that may have the data that you're looking for.

STANTON: Great, I'll look for it.

If Fannie had less than 1% fraud in the early 2000s, did you draw any inferences about what was going to happen in the broader mortgage market?

BREWSTER: We're generally aware of what was going on in the markets. As the fraud default rate went up in huge increments, Fannie's fraud default rate went up as well. It could have had to do with the factors in the market, or it's possible that people were better at finding fraud than they were before.

BORGERS: What's the make-up of the subprime, Alt-A, and prime fraud?

BREWSTER: I don't have a break-out of numbers. I think that some of the charts I've seen break out the randoms by products type. I don't know about subprime. I'm pretty sure we had it for Alt-A.

BORGERS: We've heard that Fannie would use the definition of subprime from the originator rather than Fannie's definition.

BREWSTER: It seems to me that if it's subprime it does not meet Fannie's guidelines. I don't look at it that way. Alt-A was clearly divided by product type.

CUNICELLI: Can you describe some of the patterns that you've seen?

BREWSTER: Some of the larger patterns we've seen involve condominiums, property flipping, and straw buyers. We've been trying to get data earlier in the process. I think we've gotten better quality data more recently.

STANTON: Can you describe what you do with respect to the rest of the company?

BREWSTER: We require people to notify us. We work closely with Risk on counterparty management (meetings every 2 weeks). We have an external site on statistics.

When we find fraud, we write up the specifics of the loan. For each loan where that happens, we transfer it to the NUC, and they send it out to the lender and require repurchase.

STANTON: When you find a case that someone has been taking advantage of recently issued Social Security numbers, would the company stop buying loans with recently issued Social Security numbers? Do you have that feedback mechanism?

BREWSTER: We've had several instances where we've had to recommend that service be terminated.

CUNICELLI: How big is your department?

BREWSTER: We have about 15 full-time employees and 15 contractors

CUNICELLI: What about in 2006-2007?

BREWSTER: We had about 6-7 people; we've grown by about 5 people each year.

The contractor strategy is a way of making us the right size for the business that we have. We're competing with NUC for talent.

BORGERS: Citigroup had to buy back hundreds of millions from Fannie and Freddie of 2006 and 2007 vintages. Would this come through you or through another group?

BREWSTER: It would come through our group and others.

STANTON: When you go to the credit policy or counterparty people and say that we need to limit the credit policy for the people who work with us, what is the general reaction?

BREWSTER: It's generally favorable. It depends on the Alt-A system. We felt that Alt-A policies were not consistent enough from one lender to the next. We worked on some skeleton variance. That was probably around 2006.

SMITH: Can you please define a subprime loan?

BREWSTER: This is circular, but it's any loan that Fannie or Freddie wouldn't buy. Fannie didn't buy subprime loans, so we don't have a firm idea what it was.

CUNICELLI: Were you referring to 15 employees of one contractor?

BREWSTER: No, it was a centralized clearing process in which the contractors would come from a variety of firms.,

CUNICELLI: Is this like a headhunting firm that will list job availabilities for you?

BREWSTER: Your question is better directed to the procurement folks. We'll go to the central contractor, and say that we need this many people for this work. When we hire somebody, we do it through that process. We don't know which firm they come from.

BORGERS: Can you give us an estimate of how many loans you've put back in the last year?

BREWSTER: There were $650 million of repurchases in the mortgage fraud group for 2009. It was probably Bank of America, Countrywide, Citigroup, and Chase that were the largest.

STANTON: What about Wells Fargo?

BREWSTER: Wells Fargo was selling more loans to Freddie for awhile. WaMu sold a lot to Fannie and not to Freddie.

BORGERS: There was $650 million for the fraud group. There are also other groups that were putting back product—how much were they putting back for 2009?

WALSH: We can look into that. Put it into an email for me at the end of this.

BREWSTER: In 2008, it was about $550 million. [for the fraud group]

CUNICELLI: Was the timeliness of the payments slowing down?

BREWSTER: We've noticed a lot more arguing and rebuttal from the lenders about putting back loans. We haven't had a huge problem with it, but we've seen more resistance.

BORGERS: Those other groups that are also putting back to JPMorgan, Citigroup, etc.—have they shared why they're putting loans back?

BREWSTER: Sure, there were underwriting and appraisal issues. It's the same kinds of things that we see in the fraud area.

BORGERS: Was there a lot of missing documentation?

BREWSTER: When we look at loans, we identify the type of product that it was sold under. If something was sold to us as a fully documented loan and it is missing documents, then we have a problem. Those are considered to be ineligible loans that shouldn't have been sold to us.

CUNICELLI: Do you have any feeling on whether the other group's numbers would be higher?

BREWSTER: Yes, they would be much bigger.

SMITH: Who is your Chief Risk Officer?

BREWSTER: Ken Phelan. I've had no personal interaction with him, but I interact with his team, both in our meetings every two weeks, and in some instances in a case with institutional fraud. If a lender systematically didn't pay off their loans, we'd work with the Risk team to find a resolution.

BORGERS: You have 15 internal employees and 15 external employees. If you had a bigger staff, would it correlate to a bigger number of repurchases?

BREWSTER: I would say that generally, yes, but there is a point of diminishing returns. We could add more people and still get the same production.

CUNICELLI: Who do you report to?

BREWSTER: Leslie Arrington, the Director of Investigations. She reports to Nancy Jardini, the Vice President of Enterprise Compliance and Chief Privacy Officer. She reports to Bill Senhauser, the Chief Compliance Officer and SVP, and he reports to Mike Williams.

I have two managers who report to me. The contractors technically don't report to us, but they work for us. I believe that with how we're structured, they report to my managers.

CUNICELLI: Let's talk about compensation. What have the elements of your compensation been since 2005?

BREWSTER: I've been a salaried person the whole time at Fannie Mae. I've been eligible for a discretionary bonus when I was a manager. For the eight years that I was a manager, I divided up the discretionary pool. I was also eligible for the stock purchase program, which ended in 2003 or 2004. When I was a director, I still had a salary, and the bonus structure is different and a little higher.

CUNICELLI: What was your salary and bonus in 2005?

BREWSTER: In 2005, I don't remember exactly, probably [redacted] or so. I think my salary is around [redacted] now. I think they've changed the bonuses again so now there is a bonus pool.

CUNICELLI: How can you affect outcomes on the bonus range? Is it tied to organizational or individual performance?

BREWSTER: I think organizational performance, but I'm not positive. I know that for the bonus pool that I manage for my people, I divide it up based on their performance for their personal goals.

SMITH: What have you been able to identify as contributing to or causing the financial crisis?

BREWSTER: There's a theory of multiple causes of what happened. About 2-3 years ago, there was a cartoon -- a lot of concealment about what was going on in the mortgage business. The securities were still packaged and sold as if they were the same mortgages. Securitization has become increasingly disconnected from the origination process. It's been exacerbated by all of the private-label mortgage-backed securities.

The other big factor is the real estate prices. In California, if you were a teacher, you couldn't afford a house in the area where you were teaching. People try to cut corners and get special mortgage products, and people are watching house flipping shows where you make a lot of money.

There are a of couple good books that I believe have good information:

- <u>The Chain of Blame</u> (how securitizations became caught up in production numbers)
- <u>Our Lot</u> (how affordability issues in a neighborhood can lead to fraud and lead to much bigger problems)

SMITH: Fannie Mae may have unknowingly contributed to the financial crisis. What could have been done differently to mitigate these effects, specifically in mortgage fraud?

BREWSTER: Since 2005, and even before that, we put together quite a few presentations for borrowers and people in the primary markets who needed more education about the risks. I wish we had pushed the training even harder and with more exuberance, because I think that was the right message at the time. People should have been conscious of what they were doing. They should have felt empowered to say `no' to stuff that they shouldn't have been doing.

SMITH: Additional education and training in the area of fraud could have mitigated the incidence of fraud in the mortgage area?

BREWSTER: Yes.

STANTON: Has anyone looked at stated income loans and tried to separate out what percentage of the time it's Fraud for Profit versus Fraud for Housing?

BREWSTER: We look for patterns all of the time. We try to see if there's a lynchpin that connects it all. Is this the same loan officer that has done this for multiple borrowers? Is this a person who has tried to flip a number of properties?

If we look at all of the income fraud that we found in the past few years, pattern-defined loans are dwarfed by the non-pattern-defined. 90% are not tied to a pattern.

CUNICELLI: Did affordable housing goals contribute to fraud?

BREWSTER: I think they did, but only to the extent that you would try to fit in last-second deals at the end of the year. For those, the due diligence might not have been enough. But that's a very small view of it.

KREBS: Have you looked at the compensation tied to the loan officers with fraudulent loans?

BREWSTER: We don't look at that at Fannie Mae, but there's no question that there's a commission angle to the whole thing. Commission structure varies by company. I'm sure there are some loan officers who are looking for the commission structures that allowed them the most freedom.

STANTON: What about yield-spread premiums to pay the broker?

BREWSTER: I'm not a RESPA expert, but I think it's basically the same issue as commission.

BORGERS: On the $650 million in 2009, did you file SARS?

BREWSTER: We file Mortgage Fraud Reports.

SMOLEN: The Mortgage Fraud Reports are filed to our regulator, FHFA, but in the format for FINCEN, so it ends up in the FBI. It ends up in their statistics regarding mortgage fraud.

BORGERS: Do you ever hear from the FBI about how many cases they've worked on?

BREWSTER: Not on a statistical or summary basis, but we do hear from them on an ongoing basis about investigations that they might be doing.

SMITH: During the period leading up to the crisis, do you believe that there was a significant lack of enforcement?

BREWSTER: I would have loved to have had more enforcement. In terms of law enforcement's attention, they've certainly had other things on their mind. It would be helpful to have examples to show brokers where people went to jail for fraud.

SMITH: We're seeing a lack of enforcement against the financial institutions—the lenders. Do you see that as well?

BREWSTER: Not from my standpoint, because we're constantly in repurchase arguments with the originators.

SMITH: Are you familiar with any enforcement actions being taken against any executives of these lending institutions?

BREWSTER: For large banks? I'm not familiar with that for mortgage fraud.

BORGERS: What was the volume of loans that you had to go through before you found the $650 million in fraudulent loans?

BREWSTER: I think our finding rate is about 70%. We looked at maybe $1 billion, but we try to look at as many as we can.

CUNICELLI: After the loans are closed, you buy the loans and do the underwriting with a straight random sample?

BREWSTER: There's a random sample, and there are targeted samples.

CUNICELLI: If fraud is detected, do you expand the scope of the sample and do targeted analysis?

BREWSTER: If there are 10 loans and we find 3 that are fraudulent, we'd look to find something connecting those loans. If we find some similarity, we'll take those attributes and look for loans like that in the sample and examine those.

This is an example of where our data isn't the best. We don't always have the loan officer identified. To the extent that we've had detailed data, we've been looking for patterns all along, but 2-3 years ago we didn't have that kind data available. Two to three years ago we only had data on the property addresses, the geographic areas, the lender names, etc.

SMITH: Did underwriting standards leading up to the crisis significantly deteriorate?

BREWSTER: There was an increasing reliance on automated underwriting. I don't know that that's a deterioration, but it's a shift away from traditional underwriting. You're putting the analysis in the hands of the models who are telling us that the performance of that type of loan was X over the last 10 years. I think underwriting got too automated.

KREBS: What was the automated underwriting that you used?

BREWSTER: Desktop Underwriter is the system that Fannie Mae uses.

SMITH: How could underwriting standards have been improved to minimize the incidence of mortgage fraud?

BREWSTER: I disagree with the premise of the question. I think you could discuss FICO and LTV—taking simple criteria like LTV and FICO to make a determination about whether a borrower could qualify was inadequate. That was a different type of underwriting that was probably too simplistic.

SMITH: If we look at mortgage origination as a manufacturing process, could we compare it to a process where the volume was increased while the same resources were available and the quality of the loans went down?

BREWSTER: I agree that volumes went up. So when you have higher volumes, you have to make the process more efficient. The automated underwriting had a lot of safeguards in it too that included red flags or warnings that were ignored by the lender. The industry got too efficient at originating the loans and not looking at the things that we asked them to.

STANTON: Would you know that when you looked at the loans?

BREWSTER: We wouldn't know it until the loans were being delivered to us.

I do think there's a correlation where there was a lot of volume and people were looking for corners to cut.

STANTON: To what extent did you detect that people might have been tailoring fraud to get through your filters?

BREWSTER: We looked at how many times an application was submitted and what the changes were. We introduced red flags and management feedback reports to let lenders know that an application has been submitted an exorbitant number of times.

BORGERS: How many loans have you put back for fraud in 2010 so far?

BREWSTER: We've requested about $400 million in remediation in mortgage fraud (data through the end of May).

STANTON: Is that due to a larger staff or changes in the market?

BREWSTER: It's a reflection of both. We staff based on the volume that we expect to receive. We're looking at about $1 billion this year—we're still looking at 2007 and 2008 vintages.

KREBS: What percentage of loans for which you request reimbursement are actually reimbursed?

BREWSTER: In 2007 it was 80%, and in 2008 it was 55%. It takes a few years to get repayment. We expect about 80% about every year.

SMITH: Are you getting more pushback against repurchase requests?

BREWSTER: Yes. On the fraud side, there's now a "Process Certain" argument where the lender will argue that he's done all of these 5 things on the checklist, and it was still a fraudulent loan, so we should not be putting it back.

KREBS: Do you only review loans for institutions that are still viable, or do you review all loans?

BREWSTER: Within our samples, we review all loans that are still active on our books, and that includes originators that no longer exist. The only exception would be something like IndyMac where the FDIC told us that we were done with repurchases.

STANTON: Do you have any insight or information about whether the percentage of fraud is different for a broker or an in-house lending officer?

BREWSTER: I don't have direct information. But we know that in 2007, a higher percentage of loans were broker-originated than they were today. I think we could get those numbers, but we don't have a perfect handle on them.

I have a piece of that information, but I don't have all of the information that I would need to make that analysis.

STANTON: We'll take whatever you've got.

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