REPORT TO FANNIE MAE REGARDING SHAREHOLDER COMPLAINTS BY MR. NYE LAVALLE

OCJ CASE NO. 5595

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I.
EXECUTIVE SUMMARY

The Office of Corporate Justice has retained Baker & Hostetler LLP to conduct an independent investigation of concerns expressed by Mr. Nye Lavalle, a Fannie Mae shareholder, about several Fannie Mae business practices in connection with single-family mortgages.[1] Mr. Lavalle accuses Fannie Mae of "aiding, abetting and sanctioning ... predatory lending and servicing schemes," as well as committing accounting and securities fraud, and racketeering violations. He views Fannie Mae as responsible for damage inflicted on single-family borrowers by unscrupulous lenders and servicers because Fannie Mae approves lenders and servicers, maintains servicer profiles and ratings, approves mortgage document terms and servicing requirements, and benefits from the income stream created by wrongdoing. He fears Fannie Mae's alleged failures could result in both civil and criminal liability that would affect shareholder value.

Through a series of communications to members of the Board of Directors and others starting in December 2003, Mr. Lavalle called for an independent investigation of his allegations.[2] The Board of Directors decided to conduct an internal review of these concerns. On September 12, 2005, the Office of Corporate Justice retained Baker & Hostetler LLP.

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[1] Mr. Lavalle has informed us that he personally owns Fannie Mae stock, he is the beneficiary of the Pew Family Trust which owns Fannie Mae stock and debt, and he holds proxies from other Fannie Mae shareholders. *See* E-mail dated July 22, 2005, from Nye Lavalle to Deborah M. House, Vice President and Deputy General Counsel; Daniel H. Mudd, President and Chief Executive Officer; and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff; and others; E-mail dated Feb. 15, 2006, from Mr. Lavalle to Mark Cymrot and Ambika Biggs.

[2] *See, i.e.*, E-mail dated Dec. 19, 2003, from Nye Lavalle to then Fannie Mae Chairman and Chief Executive Officer Franklin Raines and other individuals; E-mail dated Jan. 8, 2004, from Nye Lavalle to Vice President and Deputy General Counsel Deborah M. House; E-mail dated June 4, 2004, from Nye Lavalle to Mr. Raines, Ms. House and other undisclosed recipients; E-mail dated July 22, 2005, from Nye Lavalle to Ms. House, Mr. Mudd, and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff, and others; E-mail dated July 25, 2005, to the individuals referenced in July 22, 2005 e-mail; E-mail dated July 26, 2005, from Nye Lavalle to the individuals referenced in the July 22, 2005, e-mail.

Mr. Lavalle began investigating the mortgage industry after his parents, Anthony and Matilde L. Pew, had a dispute with mortgage servicer EMC Mortgage Corporation ("EMC"), a subsidiary of Bear Stearns Companies ("Bear Stearns").[3] EMC ultimately foreclosed on the Pews' property, even though, according to Mr. Lavalle, his family is wealthy and made repeated efforts to repay the loan.[4] The dispute motivated Mr. Lavalle to investigate and publicize his allegations that EMC engaged in predatory servicing practices, which has resulted in several lawsuits between Bear Stearns and Mr. Lavalle.[5] Mr. Lavalle then broadened his focus to include the single-family mortgage industry as a whole.

Mr. Lavalle considers himself a gadfly of the mortgage industry. He claims to have been investigating, analyzing and exposing mortgage fraud, predatory lending and servicing, and securitization schemes since 1993.[6] He has a website that details his complaints,

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[3] Mr. Lavalle has alleged that Bear Stearns Companies, its subsidiary EMC, and Savings of America committed predatory lending and servicing practices with regard to his parents' loan. Mr. Lavalle prepared a lengthy account of this dispute in a document he titled, *Predatory Grizzly "Bear" Attacks Innocent, Elderly, Poor, Minorities, Disabled and Disadvantaged!*

Mr. Lavalle alleges that the loan agent who originated the loan committed fraud, and either Fannie Mae, Freddie, EMC or EMC's predecessor, Savings of America, found the fraud. November 1, 2005, conversation with Mr. Lavalle; e-mail dated July 22, 2005, from Nye Lavalle to Deborah M. House, Vice President and Deputy General Counsel; Daniel H. Mudd, President and Chief Executive Officer; and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert and John Wulff; and others.

[4] Nye Lavalle, *Predatory Grizzly "Bear" Attacks Innocent, Elderly, Poor, Minorities, Disabled and Disadvantaged!*, pp. 24-25, 102; *see also Bear Stearns Companies v. Lavalle*, No. 3:00-CV-1900-D, 2000 WL 34339773, *1 (N.D. Tex. Oct. 27, 2003).

[5] Mr. Lavalle created several websites that alleged that Bear Stearns engaged in abusive and illegal business practices. *See Bear Stearns Companies v. Lavalle*, Case No. 3:00-CV-1900-D, 2000 WL 34339773 (N.D. Tex. Oct. 27, 2003)(in which the court enjoins Mr. Lavalle from using certain domain names and an e-mail address that incorporated Bear Stearns' name) and *Bear Stearns Companies v. Lavalle*, Case No. 3:00-CV-1900-D, 2002 WL 31575771 (N.D. Tex. Dec. 3, 2002). For further examples of the acrimony that exists between Mr. Lavalle and EMC and Bear Stearns, see *Bear Stearns Companies v. Lavalle*, Case No. 3:00-CV-1900-D, 2002 WL 485697 (N.D.Tex. Mar. 29, 2002); *Bear Stearns Companies v. Lavalle*, Case No. 3:00-CV-1900-D, 2001 WL 406217 (N.D. Tex. Apr. 18, 2001); and *Bear Stearns Companies v. Lavalle*, Case No. 3:00-CV-1900-D, 2001 U.S. Dist. Lexis 20633 (N.D. Tex. Dec. 11, 2001).

[6] June 04, 2004, e-mail attachment entitled *Report on Predatory Lending & Servicing Practices & Their Effect on Corporate Compliance, Conduct, Ethics & Accounting* ¶ 11. E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

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and has posted information on several other sites.[7] He claims to have spent more than 20,000 hours and nearly $500,000 investigating predatory lending and servicing.[8] He reports that he is a consultant to plaintiff lawyers who sue lenders and servicers and to homeowners.

Mr. Lavalle's view is that since Fannie Mae is such an important force in the mortgage industry, it has both the responsibility and means to end abusive lending and servicing practices. Mr. Lavalle's view is that Fannie Mae directs the conduct of servicers from afar. In an e-mail of February 21, 2006, Mr. Lavalle expresses his frustration, saying:

> I hate to keep using the analogies that you don't like but it really is like a Mafia operation. The Godfather [Fannie Mae] says we got a problem, "take care of it" and the lieutenant ["the servicer"] orders the hit [foreclosure] and hires the hitman [the USFN or other lawyer to foreclose].
>
> The hit man and lieutenant don't want the Godfather implicated so they create layers of deniability [a typical CIA, white house, legal and political maneuver] to conceal who the real parties in interest are and who had knowledge of and ordered the hit.

While Mr. Lavalle is partial to extreme analogies that undermine his credibility, he has become knowledgeable about the mortgage industry. He has identified significant issues but, in our view, does not always analyze them correctly. In proposing solutions, he generally undervalues the benefits to homeowners of efficient mortgage markets operated at low costs and overstates the needs of borrowers to have information about the status of their loans in the secondary markets for mortgages. Fannie Mae has already identified and is addressing many of the same issues. This report details several areas where Fannie Mae faces legal and business issues that

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[7] *See* Mortgage Servicing Fraud.org, http://www.msfraud.org (last visited Mar. 16, 2006). He also has posted information on EMC Sucks.org, http://www.emcsucks.org (last visited Mar. 16, 2006); Websitetoolbox, http://www.websitetoolbox.com/tool/mb/ssgoldstar (last visited Mar. 16, 2006); and Rip-Off Report.com, http://www.ripoffreport.com last visited Mar. 16, 2006).

[8] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

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remain to be addressed.

Mr. Lavalle also claims that as a result of this work, he and his family have been harassed. He expresses considerable anger when he attributes these attacks to Fannie Mae. An investigation of his personal retaliation claim is in progress; to date Mr. Lavalle has identified no direct conduct by Fannie Mae that he considers harassing.

We have reviewed more than 1,500 pages of documents provided by Mr. Lavalle to Fannie Mae or us directly and had 17 conversations with him. We have identified six general areas of his concerns: (1) foreclosure policies and procedures, (2) transparency, (3) protection of promissory notes, (4) predatory servicing, (5) fraud detection and reporting, and (6) accounting and securities issues. Within each area, Mr. Lavalle identifies multiple issues that are detailed in this report. In investigating these concerns, we have collected documents from Mr. Lavalle, Fannie Mae and public sources, reviewed extensively eFannie.com, and interviewed at least 30 Fannie Mae employees. The company has fully cooperated in our investigation.

In reviewing Mr. Lavalle's concerns as a shareholder, we have told Mr. Lavalle that the proper scope of our investigation is to determine whether he has identified wrongdoing by Fannie Mae officials or financial risks of sufficient magnitude to affect materially Fannie Mae's financial statements. We cannot resolve every case of an alleged mishandled mortgage.

1. Foreclosure Policies and Procedures

Mr. Lavalle asserts that Fannie Mae's mortgage servicers and the Mortgage Electronic Registry System, Inc. ("MERS") routinely make misrepresentations in foreclosure proceedings. He has identified two categories of alleged misrepresentations: that MERS or the servicers are the holders and owners of the defaulted promissory notes, and that promissory notes

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are lost, stolen or destroyed.[9] He also questions whether foreclosures in the name of MERS or servicers satisfy state laws on standing to sue. Since Fannie Mae authorizes foreclosures, Mr. Lavalle argues that Fannie Mae could be liable for these misrepresentations, including for racketeering violations under federal and state laws, and could risk having foreclosure sales unwound by the courts.[10]

We have found evidence that false statements by foreclosure attorneys are being routinely made in at least two counties in Florida and appear to be occurring elsewhere. Apparently due to Mr. Lavalle's *ex parte* communications, two Florida judges ordered hearings to examine MERS's role in foreclosures. During consolidated hearings that resulted in the judges dismissing 24 foreclosure actions, three judges (including one who took the time to observe and comment) criticized MERS for routinely filing "sham" pleadings and "false" affidavits regarding its interest in promissory notes and supposed lost promissory notes.[11] One judge questioned whether large numbers of foreclosures would have to be reversed due to fraud on the court.

MERS's counsel conceded false allegations are routinely made, and the practice should be "modified." He acknowledged that foreclosure counsel used the Florida Supreme Court's form pleading for foreclosures without critically analyzing the facts. The form contains an allegation that the plaintiff is the "owner and holder" of the promissory note. MERS is neither.

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[9] E-mail dated December 19, 2003, from Mr. Lavalle to Mr. Raines and others.

[10] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House and various members of Fannie Mae's Board of Directors; Nye Lavalle, report on his allegations against Fannie Mae (Feb. 2, 2006) (unpublished report), sent as attachment to e-mail dated Feb. 2, 2006, to Mark Cymrot.

[11] *See* Transcript of September 16, 2005, Hearing, *MERS v. Cabrera*, Case No. 05-02425 CA 05, pp. 15-23.

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Courts in several other states also have rejected foreclosures based upon "discrepancies" between MERS' pleadings and supporting documents. Other court opinions or reports from borrowers – provided by Mr. Lavalle – suggest the same misrepresentations are made in other states. Our review of reported decisions and pleadings from Connecticut, Illinois, Louisiana, New York, Ohio, Kentucky, and Georgia appear to contain similar false statements.

The Florida judges also criticized foreclosure counsel for routinely filing lost note affidavits and counts to reform promissory notes. Mr. Lavalle has identified cases in which the original promissory notes were produced once the court challenged the lost note affidavit. It appears the notes are not lost, and instead, false statements are being made in the pleadings and affidavits.

Masked by the improper pleadings is a substantive legal issue of whether MERS or servicers have standing to foreclose. In the two Florida cases, the judges held that MERS did not have the right to bring the foreclosure actions and dismissed the actions. These opinions are on appeal. Fannie Mae's policy instructs servicers and MERS to commence foreclosure proceedings in their own names if permitted under state laws. While this policy is based upon reasonable legal arguments and policy considerations, the issue is not resolved in case law.

It is axiomatic that the practice of submitting false pleadings and affidavits is unlawful. With his complaint, Mr. Lavalle has identified an issue that Fannie Mae needs to address promptly. For some time, the Legal Department has been working on a proposal for a new computer system to communicate better with and control attorneys working on Fannie Mae litigated matters. As a result of the Florida cases, the Legal Department is formulating a more immediate solution for the issues raised in those cases, including a directive to attorneys and servicers in Florida directing corrective action.

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While these issues present reputational and litigation risks, Mr. Lavalle's assertion that Fannie Mae faces tens of billions of dollars of unenforceable mortgages and damages from class action lawsuits is overstated in our view. Even the Florida judges who were angered at MERS's misconduct dismissed the foreclosure actions without prejudice to the proper party bringing new actions. It appears unlikely that substantial numbers of borrowers who have defaulted on their mortgages could meet the heavy legal burden to avoid foreclosure. Borrowers seeking damages also would face a difficult burden to demonstrate that Fannie Mae is responsible for the attorneys' misconduct and the conduct was the proximate cause of damages. Prompt correct action, however, should be taken and would mitigate these risks.

2. Transparency

One of Mr. Lavalle's principal themes is that the mortgage industry is not transparent to borrowers. The gulf between Fannie Mae's understanding of its role and Mr. Lavalle's contentions about its role is wide. Mr. Lavalle has a broader view of Fannie Mae's responsibilities than appears justified by its charter and the mortgage documents. On the issue of transparency, the mortgage industry has become more complex and more efficient as it has matured but with a loss of transparency to borrowers. Homeowners have benefited through lower interest rates and available mortgages. They remain entitled, as Mr. Lavalle points out, to assurances that their payments are properly credited, they have access to information concerning their mortgage balances, and they are not subject to improper charges or other harassing behavior. Fannie Mae's mortgage guidelines and servicer reviews already address these issues.

Mr. Lavalle focuses on two structural developments in the mortgage markets that have decreased the transparency of transactions to borrowers: the requirement of having notes endorsed in blank and the creation of MERS. Both developments were introduced to reduce

paperwork and the cost of transactions. They have, as Mr. Lavalle suggests, reduced somewhat the transparency from the borrowers' vantage.

Mr. Lavalle proposes that Fannie Mae return to the days when each promissory note is endorsed and each note is returned stamped "paid in full." He wants an audit trail for mortgage servicing and ownership, and he proposes that borrowers be entitled to circumvent predatory servicers by dealing directly with their note owners. He also would give borrowers access to the MERS database – which contains considerable information regarding servicing histories – for a fee.

These proposals are not practical, not legally required by the mortgage documents, and not necessary to meet borrowers' needs. Borrowers do not have a legal right or an identifiable interest in knowing the current owners of their mortgages or in the complex transactions that underlie the secondary mortgage markets. The Servicing Guide addresses borrower interests by placing disclosure obligations on the servicers. Servicing Guide III-104, for instance, provides that "The servicer also must provide a detailed analysis of all transactions relating to a borrower's payments or escrow deposit account whenever the borrower requests it." The Guide also requires servicers to disclose Fannie Mae's interest in the promissory note if a borrower asks.[12]

Mr. Lavalle's proposal that the owner or Fannie Mae, as trustee, should accept loan repayments or otherwise interact directly with borrowers is contrary to the concept of a secondary market. Ownership interests in mortgages are now fractured into a variety of income streams due to the advent of mortgage-backed securities ("MBS"). No single owner would have the means or authority to accept payments. It is also contrary to Fannie Mae's role, as stated in

[12] Servicing Guide, I-311.

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its charter, of creating and operating within a secondary market. During years of lobbying, private financial institutions and their associations have urged Congress to limit the competition Fannie Mae provides private financial institutions. Fannie Mae officials uniformly express sensitivity to Fannie Mae's limitations with regard to direct consumer contacts; Fannie Mae's customers are lenders and servicers for whom homeowners are customers.

Fannie Mae's approach appears sound and efficient, provided that servicers' disclosure obligations are enforced. As this report discusses, Fannie Mae has an extensive program for ensuring servicer compliance.

3. Protection of Promissory Notes

In Mr. Lavalle's view, the numerous lost note affidavits filed in foreclosure proceedings support the notion that notes are regularly misplaced at a risk to both Fannie Mae and borrowers. He expresses fear that Fannie Mae does not have adequate procedures to protect the 15 million freely negotiable promissory notes in its portfolio. Mr. Lavalle has identified an important legal issue – lost notes threaten the enforceability of Fannie Mae's mortgages and expose borrowers to financial risks. Mr. Lavalle, however, has not provided support, and we have not found support, for the assertion that mortgage documents are regularly lost or stolen.

Fannie Mae has extensive custodial procedures and certifies 58 private custodians, which must comply with its security procedures. Fannie Mae's in-house custodian reports minimal lost notes. Fannie Mae does not, however, have a centralized registry to identify notes lost by the other custodians or procedures for notifying or protecting borrowers. Fannie Mae's in-house custodian is subject to internal audit which is ongoing at the time of this report. It has recently instituted reviews of the certified custodians. The internal audits and external reviews should identify any issues regarding missing mortgage documents. The 2005 custodian

reviews did not find significant problems. The internal audits and external reviews do not currently specifically test security procedures for mortgage documents to ensure notes are not lost. We recommend this control be added to future reviews.

4. Predatory Servicing

Mr. Lavalle alleges that Fannie Mae has been instrumental in creating a system in which predatory servicing flourishes. He perceives servicing problems within Fannie Mae's portfolio as more pervasive than Fannie Mae officials and suggests that Fannie Mae should do more to protect borrowers. In his opinion, Fannie Mae should mandate a set of "best practices" based on a 2003 consent decree that Fairbanks Capital Corporation agreed to with the United States.[13] Mr. Lavalle's proposals often go even further than the consent decree in imposing controls but also imposing costs on servicers.

Fannie Mae has extensive procedures to review the conduct and efficiency of its servicers. In recent years, it has become more conscious of concerns about predatory servicing, as have law enforcement and regulatory officials at the federal and state levels. Fannie Mae has responded by adding Servicing Guide requirements, conducting extensive statistical analyses of servicers' portfolios, and engaging in direct servicer reviews. Fannie Mae already has responded to the Fairbanks consent decree by augmenting its Servicing Guide in 2004, and adopting, in whole or in part, the Fairbanks requirements. Where Fannie Mae has not adopted the Fairbanks requirements completely, it believes the requirements are not appropriate for its universe of servicers, which generally do not operate in the subprime markets where most of the issues have

[13] *See U.S. v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Oct. 6, 2003) (order preliminarily approving stipulated final judgment and order as to Fairbanks Capital Corp. and Fairbanks Capital Holding Corp.). In that case, the Federal Trade Commission ("FTC") and the Department of Housing and Urban Development ("HUD"), accused Fairbanks of violating the Federal Trade Commission Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act and the Real Estate Settlement Procedures Act ("RESPA"). The case was settled by a consent decree that mandated certain business practices to correct the alleged abuses.

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been found. The Fairbanks consent decree also was remedial of a serious problem; Fannie Mae believes it can safely give its servicers more discretion to deal with borrowers. These judgments appear to be reasonable.

Mr. Lavalle asserts that Fannie Mae's loan repurchasing policies result in unqualified mortgages being labeled as "scratch and dent."[14] These loans, he claims, are sold to "special servicers," which aggressively service the loans into foreclosure or bankruptcy.[15] Mr. Lavalle refers to these special servicers as "the toxic waste dump."[16] He asserts that these companies regularly defraud borrowers. Mr. Lavalle expresses particular concern about EMC Mortgage, Litton Loan Servicing, Ocwen Financial Corporation, and Select Portfolio Servicing ("SPS") (formerly Fairbanks Capital Corp). Mr. Lavalle proposes that Fannie Mae warn borrowers before transferring loans to special servicers.

Fannie Mae must have the option of protecting its financial condition by setting enforceable parameters for the mortgages it purchases. Fannie Mae, like the rest of the mortgage industry, knows that loans that do not satisfy Fannie Mae, Freddie Mac or Ginnie Mae parameters tend to be less valuable. The industry – not Fannie Mae – created the term "scratch and dent." Fannie Mae's volume of repurchases is relatively small, about 10,000 from 2002 to 2004; it owned an average of 15.2 million loans during that period.

We have reviewed Fannie Mae's oversight of the four servicers that are the target of Mr. Lavalle's strongest criticism. The four servicers are primary servicers for less than 1% of Fannie Mae's portfolio. Since the 2003 consent decree, Fairbanks has changed names to SPS,

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[14] Interview with Mr. Lavalle (Nov. 1, 2005).

[15] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors; *see also* E-mail dated Oct. 7, 2005, from Nye Lavalle to Mark Cymrot.

[16] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

ownership to Credit Suisse First Boston, and its conduct. Fannie Mae no longer believes that SPS engages in pervasive predatory servicing practices, but it monitors the company closely. The other three servicers – EMC, Ocwen and Litton – are subject to regular reviews, including on-site visits from Fannie Mae's National Servicing Organization, which has not identified significant servicing problems. Their portfolios perform on a par with other servicers. The three main rating agencies also rate these servicers with their highest or second highest subprime ratings. Fannie Mae is aware that EMC currently is the subject of a Federal Trade Commission investigation, but at this stage, Fannie Mae – like the rating agencies – has not found reason to take action against the company.

Mr. Lavalle appears to overstate the risk to borrowers of repurchases. He does not present any evidence that borrowers are regularly injured by servicers after repurchase transactions. While Fannie Mae polices its own servicers for predatory servicing practices, it is not in the position nor does it have the legal duty to police the entire industry. The general issue of predatory servicing is more appropriately the subject for state and federal regulations and enforcement.

5. Fraud Detection and Reporting

Mr. Lavalle asserts that borrowers should be informed of mortgage fraud that Fannie Mae discovers in its due diligence and quality control processes.[17] Since the promulgation of fraud regulations by the Office of Federal Housing Enterprise Oversight ("OFHEO"), Fannie Mae has implemented extensive procedures to detect and investigate mortgage fraud. The effectiveness of these relatively new procedures will have to be monitored over time. As Mr. Lavalle suggests, Fannie Mae's procedures require fraud reports be made to

[17] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

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OFHEO but not to borrowers. The OFHEO regulation does not require Fannie Mae to report suspected cases of fraud to borrowers, but also does not relieve Fannie Mae from disclosing fraud to victims or law enforcement pursuant to undefined and largely non-existent "legal requirements." Fannie Mae must take legal or business action it may deem "appropriate."

Fannie Mae's reluctance to contact borrowers arises from its lack of privity with borrowers as a secondary market company and its concern for its potential liability for the reports. The OFHEO regulation does not contain a safe harbor provision that would immunize Fannie Mae from tort suits – such as libel or interference with contract – arising from its reports. The regulation provides Fannie Mae with little guidance and requires the company to make very difficult judgments on incomplete information.

Fannie Mae has faced financial exposure for its failure to report a fraud. In the case of a fraud by First Beneficial Mortgage Corp., Fannie Mae required the lender to repurchase the loans but did not report the fraud to law enforcement authorities. After the loans were sold to Ginnie Mae, Fannie Mae agreed to pay the government $7.5 million to settle a case in which the Justice Department alleged that Fannie Mae had accepted the proceeds of a fraud.

In the case of a fraud by Olympia Mortgage Corporation ("Olympia"), however, Fannie Mae took extensive steps to ensure borrowers were made whole. In 2004, Fannie Mae discovered that a lender had not repaid prior loans after selling it refinancing loans. When Fannie Mae discovered the fraud, it reported its findings to law enforcement, transferred the portfolio to a sub-servicer with instructions to cure damage to borrowers (*e.g.*, adjustment of balances and credit histories), and issued a press release to inform investors that Fannie Mae had purchased the loans out of the pool, which would cause a quick pay down on the loans instead of

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a stream of monthly payments. Fannie Mae, however, does not have an institutional policy for reporting fraud to borrowers or other potential victims.

Fannie Mae appears to be making decisions regarding the disclosure of fraud and misrepresentation findings on an *ad hoc* basis. In our view, Fannie Mae should create a corporate policy for determining when its findings of misrepresentations or fraud in mortgage lending or servicing should be reported to law enforcement, borrowers and potential victims. The policy should balance at least five interests: (1) Fannie Mae's public mission to expand homeownership; (2) potential liability for failure to inform potential victims; (3) lack of a direct relationship with borrowers; (4) law enforcement issues; and (5) risk of liability from libel and other claims brought by the alleged wrongdoers.

6. Accounting and Securities Issues

Mr. Lavalle alleges that Fannie Mae has engaged in several forms of accounting and securities fraud. The company currently is undergoing an extensive accounting review and restatement of its financial statements. We, therefore, have not attempted to duplicate the ongoing work of independent accountants and lawyers.[18] We have limited our review to determining whether the issues raised by Mr. Lavalle are addressed through current tests and analyses designed to ensure the accuracy of financial reporting or are under review in the current review of accounting controls and restatement of financial statements.

Mr. Lavalle has focused on the following four areas: (1) impact of servicer frauds on Fannie Mae's financial statements; (2) the alleged failure to remove paid-off promissory notes

[18] *See* Report of Findings to Date, Special Examination of Fannie Mae, Office of Compliance, Office of Federal Housing Enterprise Oversight, September 17; A Report to the Special Review Committee of the Board of Directors of Fannie Mae, Paul, Weiss, Rifkind, Wharton & Garrison LLP. Fannie Mae is currently working to restate its financial statements from December 31, 2002 through June 30, 2004. It will submit its restated financial statements to its independent auditor, Deloitte & Touche LLP, so it can re-audit them. Federal National Mortgage Association, Notification of Late Filing (Form 12b-25), at 2-3 (Mar. 13, 2006).

from MBS pools; (3) the question of whether terms of MBS's comply with true sale accounting rules; and (4) whether the transfer of holder status to servicers during foreclosure proceedings are accounted for properly.

Mr. Lavalle suspects that Fannie Mae does not have adequate procedures to monitor servicer reports on mortgages, particularly when servicers are caught committing predatory lending or servicing frauds. The principal balances and loan-to-value ratios on the loans need to be re-amortized and recalculated, but Mr. Lavalle questions whether they are. Inflated property appraisals also could lead to loans that are not adequately secured, thus resulting in inaccurate financial filings. Fannie Mae, however, does extensive modeling of its portfolio to identify anomalies in loan portfolios or particular loans. It, for instance, specifically checks for duplicate loans on the same property and has developed, and is improving, sampling techniques designed to identify appraisal errors or fraud.

Mr. Lavalle's concern that paid-off promissory notes are not being removed from MBS pools is also addressed by current accounting controls. Mr. Lavalle claims to have been informed by mortgage industry executives that paid off promissory are still part of securitized pools.[19] He has not provided documentary evidence of these statements. Fannie Mae's accounting controls address these issues and their accuracy are currently under extensive review. With respect to paid-off loans, the pay down schedules are reconciled to the actual cash received to ensure that pay offs and other transactions are being properly accounted for.

[19] *Id.* In support of his allegations, Mr. Lavalle refers generally to Margery A. Colloff, "The Role of the Trustee in Mitigating Fraud in Structured Financings," J. of Structured Finance (Winter 2005). The article states "Government-reimbursed programs are at the top of the list [of hot spots for fraud]" because "[c]ollateral may be overvalued, or non-existent, or pledged to more than one transaction. No one knows because the collateral is often in the custody of the servicer or another business party, not the trustee." *Id.* at 3.

Mr. Lavalle also claims that Fannie Mae's policy of removing certain loans from MBS pools raises questions as to whether the sale is a "true sale," which affects its accounting treatment. The Rudman Report discovered one true sale issue, which Fannie Mae is now taking steps to address. In addition, Fannie Mae did not obtain true sale legal opinions prior to the recent restatement. It now has two law firms reviewing true sale questions.

Mr. Lavalle questions how promissory notes are accounted for on servicers' and Fannie Mae's accounting books when Fannie Mae transfers holder status to the servicer at the time of foreclosure. It appears that Mr. Lavalle has incorrectly analyzed the issue. Even when holder status changes, ownership does not change; thus, mortgages are properly maintained on Fannie Mae's books as assets.

II.
THE PROBLEM IN FORECLOSURES

A. Mr. Lavalle's Assertions about Foreclosures

Mr. Lavalle contends that MERS and servicers are routinely making false statements regarding their interest in promissory notes and routinely filing lost note affidavits. In support of his claim, Mr. Lavalle has provided court transcripts and opinions. In two Florida cases, judges dismissed 24 foreclosure actions in which MERS misrepresented it was the holder and owner of notes, when it is neither.[20] The courts found that MERS had submitted "sham" pleadings.[21]

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[20] *In re Mortgage Electronic Registration Systems, Inc.* (MERS), No. 05-001295CI-11 *et al.* (Fla. Cir. Ct. Aug. 18, 2005) (order regarding standing of MERS to foreclose on behalf of others); *MERS v. Cabrera*, No. 05-245 CA 05 *et al.* (Fla. Cir. Ct. Sept. 28, 2005) (order of dismissal on the corrected order to show cause).

[21] *Mortgage Electronic Registration Systems v. Cabrera*, No. 05-245 CA 05 *et al.* (Fla. Cir. Ct. Sept. 28, 2005) (order of dismissal on the corrected order to show cause).

He also provided us with opinions from Connecticut, New York, and Georgia, courts that have found discrepancies between a MERS affidavit and the exhibits.[22] The same allegations are referred to in a Kentucky case and in an email by an Ohio borrower.[23]

The cases raise a substantive issue of whether MERS has standing to conduct foreclosures.[24] MERS, Mr. Lavalle points out, has taken inconsistent positions in different cases. While MERS claims it can conduct foreclosures in its own name, MERS successfully defeated a borrower's effort to cancel a note, in part, by arguing that the borrower had failed to join an indispensable party, Fannie Mae.[25]

With regard to lost note affidavits, Mr. Lavalle suggests Fannie Mae has a serious dilemma. If the notes are not, in fact, missing, Fannie Mae could be liable for the misrepresentations to the courts, he argues; while if the promissory notes actually cannot be produced, borrowers may be relieved of liability for the notes.[26]

Mr. Lavalle alleges that MERS allows Fannie Mae to hide the fact that it is a real party in interest in foreclosure actions and avoid assignee liability issues.[27] Mr. Lavalle has

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[22] *See Mortgage Electronic Registration Systems v. Rees*, No. 2003 Conn. Super. Lexis 2437 (Conn. Super. Ct. Sept. 4, 2003) (unreported); *Mortgage Electronic Registration Systems v. Burek*, 798 N.Y.S.2d 346 (N.Y. Supp. 2004)(summary judgment motion denied based in part on an inconsistency between complaint and its reply affirmation); *Taylor, Bean & Whitaker Mortgage Corp. v. Brown*, 583 S.E.2d 844 (Ga. 2003) (reversed holding of trial court that cancelled note but remanded for determination whether MERS as nominee of the lender had the power to foreclose).

[23] *See Waggoner v. Mortgage Electronic Registration Systems*, No. 2003-CS-002666-MR, slip op. (Ky. Ct. App. Sept. 5, 2005) (affirming summary judgment for MERS in a foreclosure action).

[24] *Mortgage Electronic Registration Systems v. Thompson*, No. 2002 Conn. Super. Lexis 828 (Conn, Super. Ct. Mar. 14, 2002) (unreported); *Mortgage Electronic Registration Systems v. Pressman*, No. 2005 Conn. Super. Lexis 82 (Conn. Super. Ct. Jan. 7, 2005) (unreported).

[25] *Taylor, Bean & Whitaker Mortgage Corp. v. Brown*, 583 S.E.2d 844 (Ga. 2003). Fannie Mae involuntarily terminated Taylor, Bean & Whitaker Mortgage Corp. as a servicer in 2002. March 3, 2006, e-mail attachment of a chart of all terminations in 2002, from Marianne Sullivan, Senior Vice President, Credit Loss Management.

[26] E-mail dated Dec. 19, 2003, from Nye Lavalle to then-Fannie Mae Chairman and Chief Executive Officer Franklin Raines and other Fannie Mae employees, as well as other individuals.

[27] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

communicated with MERS General Counsel, Sharon Horstkamp, regarding his concerns that MERS is committing fraud on the courts.[28] Mr. Lavalle states that his communications with Fannie Mae and MERS, as well as the court opinions, put Fannie Mae on notice of the fraudulent conduct of MERS and the servicers, which Mr. Lavalle considers to be agents of Fannie Mae.[29]

These practices not only expose Fannie Mae to liability, he asserts, but also may result in foreclosures being unwound. Mr. Lavalle claims that the alleged fraud regarding ownership of the notes and lost note affidavits violates federal and state Racketeer Influenced and Corrupt Organizations ("RICO") acts and parties engaging in the fraud face both civil and criminal liability.[30] He states that the number of civil conspiracy claims against these Fannie Mae, MERS, and servicers will increase.[31] He claims to be consulting with the counsel for a class action brought by victims who were foreclosed upon illegally.[32] If counsel for the class action seeks to void all prior foreclosures in Florida, Fannie Mae shareholders, as well as servicers, investors, and MERS shareholders, could potentially lose tens of billions of dollars, Mr. Lavalle asserts.[33] This large figure results from the compensation that the victims would be due, as well as the compensation due to new homeowners whose title to the property may be clouded due to the fraud, he claims.[34]

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[28] *See* Letter from Nye Lavalle to Sharon Horstkamp, MERS General Counsel, informing her of his allegations of MERS committing fraud (September 15, 2005).

[29] Telephone interview with Nye Lavalle (November 1, 2005).

[30] E-mail dated Feb. 15, 2006, from Mr. Lavalle to Mark Cymrot and Ambika Biggs.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

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He asserts that he has spoken with hundreds of victims and read their postings on his website and forum.[35] Some of the victims have lost everything due to the fraud, Mr. Lavalle claims, and some have committed suicide or are suicidal.[36] In addition, he believes that a "troubled and victimized borrower" may one day kill a major Wall Street executive or mortgage servicer as a result of the fraud.[37]

B. MERS Foreclosure Procedures

MERS regularly brings foreclosure actions on behalf of parties that own a beneficial interest in mortgages registered on its system. MERS was conceived as a registry for mortgages; the original concept did not include the idea that MERS would conduct foreclosures in its own name.[38] Fannie Mae, Freddie Mac, Ginnie Mae, the Mortgage Bankers Association of America, HUD and VA created MERS to simplify the process of transferring interests in mortgages.[39] Fannie Mae is a MERS shareholder, as well as one of 15 charter members.[40] Fannie Mae also has a permanent seat on MERS' Board of Directors.[41]

MERS reduces the need for paper mortgage assignments and the payment of recordation fees when mortgage rights are transferred.[42] Documents from MERS' creation show

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[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] E-mail dated Nov. 7, 2005, from Daniel C. Smith, Deputy General Counsel, Legal Department, to Mark Cymrot.

[39] MERS is a Reality!, an undated document created by MERS announcing that MERS has been formally launched [hereinafter MERS is a Reality!]. Fannie Mae, Freddie Mac, Ginnie Mae and MBA published the Whole Loan Book Entry White Paper in October 1993, and MERS was incorporated on October 16, 1995. *Id.* According to Fannie Mae's August 18, 1997, Announcement, "Fannie Mae [was] an active supporter of MERS since the concept of electronic tracking was first discussed in 1993, contributing substantial resources and effort to help the concept come to fruition."

[40] MERS Overview; MERS: About Us: Shareholders, available at http://www.mersinc.org/about/shareholders.aspx; MERS State by State MERS Recommended Foreclosure Procedures.

[41] Telephone interview with Robert Engelstad, Vice President for Policy and Standards (February 21, 2006).

[42] MERS is a Reality!, pp. 1, 10.

that the creators contemplated MERS assigning mortgages out of its system in the case of foreclosures, and having this assignment recorded in the land records.[43] We have not been able to determine when or why MERS began bringing foreclosure actions in its name; the Fannie Mae employees involved have since left the company. Presumably, it began offering this service because it adds efficiency by eliminating the need for a mortgage assignment from MERS to the foreclosing servicer.

MERS, however, has not instituted controls over the servicers who conduct foreclosures or their attorneys. MERS has the servicer retain counsel. MERS has authorized an employee of the servicer to act as an officer of MERS for the purpose of approving pleadings. MERS' Recommended Foreclosure Procedures state that employees of the servicers will be MERS certifying officers.[44] A MERS corporate resolution gives these certifying agents the power to sign any necessary documents as a MERS officer.[45] This practice enables in-house transfer of possession of the note from the servicer to MERS, in cases in which the foreclosing party has to be the note holder.[46]

C. MERS Florida Embarrassment

Two Florida trial courts recently have criticized MERS for false pleadings in foreclosure proceedings. Mr. Lavalle apparently approached judges in two Florida counties with sufficient information to prompt the judges to call extraordinary hearings.

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[43] *See* Mortgage Electronic Registration System, Legal Issues Work Team, Mortgage Bankers Association of America, August 25, 1994, p. 9. *See also* MERS Kick Off Meeting Minutes, p. 10, stating "Either the clearinghouse as the mortgagee of record will have to handle foreclosures and execute and record releases or a procedure will have to be developed for another party – the servicer or custodian – to handle one or both of these matters through an assignment or a power of attorney."

[44] *See* State-by-State MERS Recommended Foreclosure Procedure.

[45] *Id.*

[46] *See, e.g.*, MERS Recommended Foreclosure Procedure for Connecticut.

In *MERS v. Cabrera*, the judge started an extraordinary show cause hearing regarding nine foreclosure cases by reading portions of inquiries from Mr. Lavalle and his mother, Ms. Pew.[47] MERS counsel was forced to concede that the complaints contained inaccurate allegations regarding its interests in promissory notes.[48] The complaints allege that MERS is the "holder and owner" of promissory notes when neither is true. This allegation hides the relationships of the parties who will benefit from the foreclosure and masks a serious legal issue. The judge was troubled that MERS changed its stance after filing "thousands and thousands of cases" stating that it owns the note.[49]

A second judge (who took the time to observe the hearing) criticized MERS for routinely filing lost note affidavits and counts to reform the promissory notes. It appears the notes are not lost but lawyers or servicers find it easier and quicker to claim the notes cannot be found. The judge pointed out the inconsistency of the affidavit to the MERS complaint, asking:

> Where is it at the time it is lost in all of these myriad hundreds of cases which alleged that it's in our possession at the time it was lost or destroyed?[50]

The judge accused MERS of filing "false affidavits" and questioned whether foreclosures should be allowed to go forward.[51] MERS' attorney made the concession that "My understanding is lost note affidavits and lost note counts are routinely filed by mortgagees and note holders ..."[52] He acknowledged the practice should be "modified."[53]

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[47] *See* Transcript of September 16, 2005 Hearing at 15-23, *MERS v. Cabrera*, No. 05-245 CA 05 *et al.* (Fla. Cir. Ct. Sept. 16, 2005).

[48] *Id.* at 25.

[49] *Id.* at 58-59.

[50] *Id.* at 49.

[51] *Id.* at 52.

[52] *Id.*

[53] *Id.* at 54.

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In an order of dismissal dated September 28, 2005, the court dismissed four foreclosures as a "sham and/or frivolous pleading," but dismissed them without prejudice so that the true owners and holders of the notes could file their own foreclosure actions.[54]

The court also criticized MERS' practice of certifying servicers' employees as certifying officers, saying: "[t]he use of designating employees of the servicer as officers of MERS in order to circumvent the 'technical' requirement of law is transparent."[55] He called the practice a "charade."[56]

A judge in the Pinellas County, Florida, circuit court issued an order dismissing 20 MERS foreclosures for essentially the same reasons. Judge Logan noted the false allegations, stating:

> "The standard allegation in the Complaint alleged that ... 'Plaintiff now owns and holds a mortgage note and mortgage ...' The Court never found that allegation which is contained in all of the MERS Complaints to be supported by a review of the documents within the Court file."[57]

Fannie Mae does not authorize attorneys to represent that MERS holds or owns promissory notes. The Servicing Guide states "MERS will have no beneficial interest in the mortgage, even if it is named as the nominee for the beneficiary in the security instrument."[58]

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[54] *MERS v. Cabrera*, No. 05-245 CA 05 *et al.* at 5, (Fla. Cir. Ct. Sept. 28, 2005) (order of dismissal on the corrected order to show cause). The court held a show cause hearing for nine consolidated actions on September 16, 2005, but five of the cases were voluntarily dismissed before the issuance of the Corrected Order to Show Cause. *Id.* at 2.

[55] *Id.* at 13.

[56] *Id.* at 42.

[57] *In re Mortgage Electronic Registration Systems, Inc.* (MERS), at 2, No. 05-001295CI-11 *et al.* (Fla. Cir. Ct. Aug. 18, 2005) (order regarding standing of MERS to foreclose on behalf of others).

[58] Servicing Guide, I-407. *See also* Selling Guide, IV-103 ("Even when MERS is named as the nominee for the beneficiary in the security instrument, it will have no beneficial interest in the mortgage.").

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MERS is appealing Judge Logan's ruling on standing, but has ceased all foreclosure actions brought in the name of MERS in Florida in the meantime.[59] In addition, MERS revoked the authority of MERS certifying officers to bring foreclosure actions in Florida.[60] Fannie Mae has joined in filing an amicus brief with Freddie Mac, the Mortgage Bankers Association, Chase Home Finance LLC, and Countrywide Home Loans, Inc., in which they argue that affirming the circuit court's decision on standing would result in higher credit costs, reduced efficiency in the mortgage industry, and impair federal housing policy.[61] To our knowledge, however, MERS has not addressed the issue of its counsels' repeated false statements to the courts.

Mr. Lavalle claims that he is preparing a detailed *ex parte* report that he will submit to Judges Logan and Gordon in which he will offer all of his tapes, e-mail, reports and other information that show Fannie Mae, MERS, EMC, BankOne, Merrill Lynch and United States Foreclosure Network ("USFN") attorneys have been on notice of this issue.[62] He has not shared this report with us. He is also reviewing pleadings in other counties and claims to have found similar false statements in those counties.

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[59] MERS September 23, 2005, press release entitled "MERS Suspends Foreclosures In Florida," available at http://www.mersinc.org/newsroom/press_details.aspx?id=178.

[60] *See* Proposed Changes to Rule 8 (stating "In the state of Florida, the power to conduct foreclosures in the MERS granted to a Member's Certifying Officers under Paragraph 3 of the Member's MERS Corporate Resolution is revoked. Effective January 19, 2006, the Member shall be sanctioned $10,000.00 per violation for commencing a foreclosure in Florida in the name of MERS.") *See* E-mail from Adam L. Bendett of Reiner, Reiner & Bendett, PC to Daniel Gray, Associate General Counsel, stating the proposed changes to the rule will go into effect on January 19, 2006 (December 12, 2005).

[61] *See* Consolidated Joint Amicus Brief, *Mortgage Electronic Registration Systems v. Azize*, No. 2D05-4544 (Fla. Dist. Ct. App. Jan. 27, 2006). *Azize* was one of the cases dismissed in the August 18, 2005 order.

[62] E-mail dated Feb. 15, 2006, from Mr. Lavalle to Mark Cymrot and Ambika Biggs.

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D. False Statements May Be Occurring Elsewhere

MERS' concession that false statements are routine does not appear to be isolated to Florida. Other courts have questioned the accuracy of MERS' pleadings. A review of reported cases and pleadings reveal that MERS counsel are misrepresenting to courts that MERS is the owner or holder of defaulted promissory notes in at least 7 states. While these reported cases are small in number, the law firms undoubtedly are making the same representations in other foreclosures, and given the experience in Florida, these cases could be indicative of a broader problem within these states. While Fannie Mae officials do not have a single opinion, some officials believe foreclosure counsel are sacrificing accuracy for speed.

Connecticut, New York, and Georgia courts have found "discrepancies" in MERS' pleadings. In *Mortgage Electronic Registration Systems v. Thompson*, a trial court dismissed a foreclosure action brought by MERS after it had ruled in MERS' favor and title to the property had passed.[63] In that case, the homeowner of the foreclosed property moved to reopen the judgment, arguing that MERS did not have standing to bring the foreclosure action because it did not own the mortgage at the time it initiated the action, and the court agreed.[64] *See also Mortgage Electronic Registration Systems v. Rees*, No. 2003 Conn. Super. Lexis 2437 (Conn. Super. Ct. Sept. 4, 2003) (unreported) (motion for summary judgment denied because of a discrepancy between an affidavit and the promissory note); *Mortgage Electronic Registration Systems v. Pressman*, No. 2005 Conn. Super. Lexis 82 (Conn. Super. Ct. Jan. 7, 2005)(unreported)(motion to strike special defenses denied including one that alleged that MERS did not have standing to enforce the indebtedness); *Mortgage Electronic Registration Systems v.*

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[63] *Mortgage Electronic Registration Systems v. Thompson*, No. 2002 Conn. Super. Lexis 828, at *2 (Conn, Super. Ct. Mar. 14, 2002) (unreported).

[64] *Id.* at *2.

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Burek, 798 N.Y.S.2d 346 (N.Y. Supp. 2004)(summary judgment motion denied based in part on an inconsistency between complaint and its reply affirmation); *Taylor, Bean & Whitaker Mortgage Corp. v. Brown*, 583 S.E.2d 844 (Ga. 2003)(reversed holding of trial court that cancelled note but remanded for determination of whether MERS as nominee of the lender had the power to foreclose).

Mr. Lavalle provided us with other examples in which MERS claimed to be the owner or holder of the note, or used a lost note affidavit. *See Waggoner v. Mortgage Electronic Registration Systems*, No. 2003-CS-002666-MR, slip op. (Ky. Ct. App. Sept. 5, 2005)(affirming summary judgment for MERS in a foreclosure action); and *Mortgage Electronic Registration Systems v. Andrews*, No. 05-CA-007881, Lost Instrument Aff. (Fla. Cir. Ct. Nov. 10. 1005).

Our research also revealed other cases in Illinois, Ohio, Louisiana and Connecticut in which MERS claimed to hold or own the promissory notes. *See Freedom Mortgage Corp. v. Burnham Mortgage*, No. 03 C 6508 2006 U.S. Dist. LEXIS 10538, *46 n.14 (N.D. Ill. Mar. 13, 2006)(stating that the verified complaints in foreclosure actions stated MERS was the owner and legal holder of the note, mortgage and indebtedness); *Mortgage Electronic Registration Systems v. Akpele*, C.A. No. 21822, 2004 Ohio App. LEXIS 3052, *7 n. 2, *13 (Ohio Ct. App. June 30, 2004)(stating that MERS' affidavit asserted that MERS was the holder of the note and mortgage and holding that MERS was the holder, but reversing the lower court's grant of summary judgment for other reasons); *Mortgage Electronic Registration Systems v. Barclay*, No. 05AP-58, 2005 Ohio App. LEXIS 3375 (Ohio Ct. App. July 21, 2005)(stating that MERS' complaint asserted that it was the owner and holder of the note and mortgage and affirming the trial court's denial of relief to the appellant from a default judgment in a foreclosure action); *Mortgage Electronic Registration Systems v. Richard*, 889 So. 2d 1126, 1126

(La. Ct. App. 2004) (stating that MERS alleged in a petition for executory process that it was the holder of the mortgage); *Mortgage Electronic Registration Systems v. Dorcely*, CV020187258NS, 2002 Conn. Super. LEXIS 3086, *1, *7-8 (Conn. Super. Ct. Sept. 18, 2002)(unreported)(stating that MERS alleged it was the holder of the note and mortgage and denying MERS' motion to strike the defendants' special defenses because it had not recorded an assignment of the mortgage); *Mortgage Electronic Registration Systems v. Leslie*, CV044001051, 2005 Conn. Super. LEXIS 1360, *5 (Conn. Super. Ct. May 25, 2005)(unreported)(denying the defendants' motion to strike and holding that MERS had standing to bring a foreclosure action because it alleged in its complaint that it was the mortgagee and holder of the note and mortgage); *Mortgage Electronic Registration Systems v. Serencsics*, CV000339985S, 2000 Conn. Super. LEXIS 3028, *2, *4 (Conn. Super. Ct. Nov. 16, 2000)(unreported)(stating that MERS filed and served an affidavit stating that it was the holder of the mortgage and note and granting MERS summary judgment on the issues of default and the right to foreclose); and *Mortgage Electronic Registration Systems v. Socci*, CV020190866S, 2003 Conn. Super. LEXIS 1490, *1, *3 (Conn. Super. Ct. May 16, 2003) (unreported) (stating that MERS's affidavit showed that was the owner of the note and mortgage and granting MERS' motion for summary judgment as to liability).

MERS recently amended its Rules of Membership to prevent servicers from pleading that MERS owns the note and to require MERS certifying agents to have possession of the note before conducting foreclosures in MERS' name.[65]

[65] Proposed Changes to Rule 8, Foreclosure, Section 2. *See* E-mail from Adam L. Bendett of Reiner, Reiner & Bendett, PC to Daniel Gray, Associate General Counsel, stating the proposed changes to the rule will go into effect on January 19, 2006 (December 12, 2005).

E. Servicers Standing to Foreclose

While MERS took the brunt of the public criticism for false affidavits, servicers' counsel were the ones representing MERS and filing the false statements. There is no reason to believe they are acting any differently when representing servicers directly.[66] The legal issue of whether servicers have standing to bring foreclosures also is unresolved, although there are more precedents supporting servicer standing.

Fannie Mae's position is that servicers have a beneficial interest in the mortgages they service, the servicing rights.[67] When borrowers remit their fees to servicers each month, the servicers forward most of the payment to Fannie Mae, the owner or trustee of the notes, but they also receive a portion of the payments as their servicing fee. Fannie Mae's position is that ownership of servicing rights is a sufficient interest to give servicers standing to bring foreclosure actions.[68]

At least one court has found specifically that a mortgage servicer has standing to foreclose. *Fairbanks Capital Corp. v. Nagel*, 289 A.2d 99 (N.Y. App. Div. 2001) (servicer had

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[66] Mr. Lavalle has provided us with pleadings in which MERS was not the plaintiff, and the plaintiff or servicer alleged the note was lost. *See, i.e.*, Complaint, *Bank One v. Calcaterra*, No. 0008468 (Fla. Cir. Ct., n.d.) (which includes a count to reestablish a lost note); Plaintiff's Affidavit, *Bank One v. Grusczynski*, No. 00-9764 B (Fla. Cir. Ct. Feb. 16, year indecipherable) (in which a Fairbanks employee asserts that the original note has been lost); Complaint, *Bank One v. Piette*, No. 01005784 (Fla. Cir. Ct. Jul. 12, 2001) (which includes a count to reestablish a lost note); Complaint to Foreclose Mortgage and to Enforce Lost Loan Documents, *Bankers Trust Co. v. Jackson*, No. 01005591 (Fla. Cir. Ct. July 5, 2001); Lost Instrument Affidavit, *Bankers Trust Co. v. Jackson*, No. 01005591 (Fla. Cir. Ct. July 17, 2001); Affidavit as to Lost or Misplaced Original Note, *Cendant Mortgage Corp. v. Corrigan*, No. 50-2004-CA-742 (Fla. Cir. Ct. Feb. 4, 2004); Complaint in Mortgage Foreclosure, *Deutsche Bank National Trust Co. v. Stephens*, No. 05-04002 (Fla. Cir. Ct. May 5, 2005) (which includes a count to reestablish a lost note); Affidavit of Lost Note, *Deutsche Bank National Trust Co. v. Stephens*, No. 05-04002 (Fla. Cir. Ct. May 20, 2005); Complaint, *Deutsche Bank National Trust Co. v. Sherman*, No. 05004405 (Fla. Cir. Ct. May 19, 2005) (which includes a count to reestablish a lost note); and Complaint to Foreclose Mortgage and to Enforce Lost Loan Documents, *SFJV-2004-1 LLC v. Boykin*, No. 05-03202 (Fla. Cir. Ct. Apr. 11, 2005). Mr. Lavalle also provided e-mail from a borrower from Ohio who claims that the servicer in a foreclosure action against the borrower falsely stated that it was the owner and holder of the note. The borrower claims to be preparing a motion to vacate the foreclosure judgment because the servicer allegedly did not have standing to bring the action. *See* E-mail dated Feb. 21, 2006, from Nye Lavalle to Mark Cymrot, which includes e-mail correspondence from the borrower.

[67] Interview with Daniel C. Smith, Deputy General Counsel, Legal Department (October 14, 2005).

[68] *Id.*

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standing to sue based on the trustee's delegation of authority over the mortgage). Bankruptcy court precedents also support the servicer. (*In re Raymond C.Q.K.T.N.W. Tainan*, 48 B.R. 250 (Bankr. E.D. Pa. 1985) (servicer in its capacity as representative for collection purposes of Fannie Mae was a real party in interest); *Greer v. O'Dell,* 305 F.3d 1297 (11th Cir. 2002) (credit card servicer was a real party in interest).

Mr. Lavalle, nonetheless, suggests that foreclosures could still be unwound because an indispensable party, the owner of the promissory note, was not a party to the action. Three cases from lower courts do not resolve the issue, and therefore the accuracy of pleadings is particularly important to avoid misleading borrowers and the courts. Fannie Mae is entitled to take the legal position that MERS or servicers have standing to sue, provided the pleadings clearly set forth the facts.

F. Fannie Mae's Current Policy on Foreclosures

Fannie Mae's Servicing Guide states that routine legal proceedings generally should not be initiated in Fannie Mae's name, even though it would clearly satisfy the standing requirements in all states as the owner and holder of the promissory note.[69] Foreclosures are conducted in Fannie Mae's name only when it is the mortgagee of record, which generally means it is an older loan, or if a filing in MERS or the servicer's name would require the imposition of a transfer tax.[70] The Servicing Guidelines express a preference for naming MERS as plaintiff.[71]

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[69] Servicing Guide, VIII-102.

[70] Servicing Guide, VIII-105.

[71] *Id.* It states: "In either situation, the attorney (or trustee) should subsequently have title vested in our name in a manner that will not result in the imposition of a transfer tax. Examples of ways to accomplish this include the assignment of the foreclosure bid or judgment to us, inclusion of appropriate language in the judgment that directs the sheriff or clerk to issue a deed in our name, recordation of an assignment of the mortgage or deed of trust to us immediately before the foreclosure sale, recordation of a grant deed to us immediately following the foreclosure sale, etc. The servicer and its selected foreclosure attorney (or trustee) must determine the most appropriate method to use in each jurisdiction. ..."

Fannie Mae's guidelines do not provide specific pleading guidelines. Servicers and their attorneys are required to comply with the applicable state laws.[72]

Although foreclosure actions generally are not to be initiated in Fannie's name, the Guide states that if the borrower asks who owns the note, the servicer is to inform them that Fannie Mae owns it.[73] Fannie Mae's position is that by having the servicer foreclose, the borrower continues to deal with the company with whom it already has a relationship. The servicer is in the best position to make adjustments to loan records and has the most detailed information about the loans. In addition, if the borrower has complaints, it is likely against the servicer, and they can be litigated during the foreclosure.

On the issue of producing the promissory note during the foreclosure, the Servicing Guide states that most servicers have a copy of the note and can begin foreclosure proceedings with copies in jurisdictions that allow it.[74] For jurisdictions that require the original note, the servicer can request it from Fannie Mae.[75] For jurisdictions that allow only the "holder" of the note to conduct a foreclosure, Fannie Mae transfers possession of the note to the servicer temporarily in accordance with a statement in its Servicing Guide, which says:

> In some jurisdictions, only the "holder" of the note may conduct a foreclosure. In any jurisdiction in which our servicer must be the holder of the note in order to conduct the foreclosure, we

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[72] Servicing Guide, I-306.

[73] Servicing Guide, I-311.

[74] Servicing Guide, VIII-102. It states: "In most cases, a servicer will have a copy of the mortgage note that it can use to begin the foreclosure process. However, some jurisdictions require that the servicer produce the original note before or shortly after initiating foreclosure proceedings. If our possession of the note is direct because the custody documents are at our document delivery facility, to obtain the note and any other custody documents that are needed, the servicer should submit a request to our Custody Department through the Loan Document Request System (LDRS) on our Web site (www.efanniemae.com). If we possess the note through a document custodian that has custody of those documents for us, to obtain the note and any other custody documents that are needed, the servicer should submit a *Request for Release/Return of Documents* (Form 2009) to our custodian. In either case, the servicer should specify whether the original note is required or whether the request is for a copy."

[75] *Id.*

> temporarily transfer our possession of the note to our servicer, effective automatically and immediately before commencement of the foreclosure proceedings. When we transfer our possession, our servicer becomes the holder of the note during the foreclosure proceedings.[76]

In Fannie Mae's view, no documents need be exchanged or physical possession of the note passed to signify a change in holder status. The Guide states:

> The transfer of our possession, and any reversion of possession to us, are evidenced and memorialized by our publication of this paragraph. This Guide provision may be relied upon by a court to establish that the servicer conducting the foreclosure proceeding has possession, and is the holder, of the note during the foreclosure proceeding, unless the court is otherwise notified by Fannie Mae.[77]

Possession of the note automatically reverts to Fannie Mae if the borrower reinstates the loan or the servicer stops servicing the loan for Fannie Mae.[78]

Fannie Mae's position has a reasonable legal basis, but the courts may or may not accept it. The issue is whether stating that holder status is transferred without a physical transfer of the note is enough to make the servicer the holder. The U.C.C. defines a "holder" as: "(A) the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession . . . ."[79] In order to be a holder, the servicer must be in possession of the promissory note that was endorsed in blank to Fannie Mae.

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[76] *Id.* For instance, a Connecticut appellate court has held that an entity must be a holder of a promissory note in order to initiate foreclosures. *See Fleet National Bank v. Nazareth*, 818 A.2d 69, 72 (Conn. App. 2003) (holding that a Connecticut statute allows a holder of a note who has not had the mortgage assigned to him to foreclose, but that an assignee of the mortgage who does not hold the note cannot foreclose).

[77] *Id.*

[78] *Id.* It states: "If the borrower reinstates the loan or the servicer ceases to service the loan for Fannie Mae for any reason, then possession of the note at that time automatically reverts to Fannie Mae and the note must be returned to the document custodian. At that time, Fannie Mae also resumes being the holder, just as it was before the foreclosure proceedings."

[79] U.C.C. § 1-201(21).

In *MERS v. Cabrera*,[80] the trial court held that MERS did not have physical possession of the promissory notes, as it alleged, and thus it did not "hold" the notes. It stated when a note is in the hands of an agent, the principal can have constructive possession of the note.[81] However, the converse was not true.[82] As MERS was an agent of the servicer or the owner of the note, it could not have constructive possession based on the servicer's possession of the note, the court held.[83] This decision is now on appeal and Fannie Mae has supported its position with authorities in an *amicus* brief.[84]

G. Fannie Mae's Oversight of Foreclosure Attorneys

Most foreclosures are conducted by servicers (even where MERS or Fannie Mae are the named plaintiff), and the servicers are responsible for choosing counsel. Fannie Mae, through its National Servicing Organization ("NSO"), has established a Retained Attorney Management Network ("RAMN"), which acts as a listing of preferred counsel.[85] Servicers can

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[80] *MERS v. Cabrera*, No. 05-245 CA 05 *et al.* (Fla. Cir. Ct. Sept. 28, 2005)(order of dismissal on the corrected order to show cause). The court used a slightly different definition of "holder." Florida Statute § 671.201(20) defines holder as: "'Holder,' with respect to a negotiable instrument, means the person in *possession* if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in *possession*. 'Holder,' with respect to a document of title, means the person in *possession* if the goods are deliverable to bearer or to order of the person in possession."

[81] *Id.* at 13.

[82] *Id.*

[83] *Id.* at 13.

[84] The trial court's view, however, has support. Gilmore's treatise on Security Interests in Personal Property takes the position that a written declaration is insufficient to "give him the right to collect the instrument from the obligor." *See Investment Service Co. v. Martin Bros. Contained & Timber Products*, 465 P.2d 868 (Or. 1970), quoting I Grant Gilmore, *Security Interests in Personal Property* § 1.2, 11 (1965). The Supreme Court of Oregon has stated that "it is questioned under the U.C.C. whether constructive possession is sufficient [for recovery on a negotiable instrument]." *Id. Cf. In re Big Squaw Mountain Corp. v. Big Squaw Mountain Corp.*, 122 B.R. 831, (Bankr. Me. 1990) (stating "Certainly, were we considering an attempted transfer for security of a negotiable instrument by a separate writing, unaccompanied by delivery of the instrument itself, the opportunity for mischief would exist, and the transfer would not be effective against third parties.").

[85] Servicing Guide, VIII-104.02; e-mail from Adam Womack, Servicing Process Manager, Quality Assurance (December 19, 2005). .

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choose to retain a RAMN counsel or operate outside of Fannie Mae's network.[86] Fannie Mae has a retainer agreement with RAMN counsel.[87] Fannie Mae's Servicing Guide contains time guidelines for the efficient handling of defaults and foreclosures.[88] Servicers who retain RAMN counsel are relieved of penalties for delays.[89] About 21 percent of foreclosure actions are RAMN network cases.[90]

If the servicer chooses not to work within the RAMN network, it can retain counsel of its own choosing. Fannie does not have a retainer agreement with non-network counsel. In those cases, the attorney-client relationship appears to be between the servicer and the attorney. The Servicing Guide Art VIII, 104.01 imposes upon servicers the responsibility for monitoring all aspects of the performance of any foreclosure attorney or trustee it retains,

Fannie current servicer oversight does not review attorney pleadings or litigation conduct. Servicing specialists, who are a part of the NSO's Centralized Servicing Operations Division,[91] are responsible for attorney supervision, as well as loss mitigation, loan administration, and default management (which includes foreclosures and bankruptcy).[92] Loan administration includes reviewing loan level delays in foreclosures and bankruptcies to determine whether to assess penalties against servicers and reviewing reports of delinquent loans

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[86] Servicing Guide, VIII-104. In many cases, servicers will conduct a foreclosure out of the network, even though the attorney they select is part of RAMN. Telephone interview with Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005).

[87] Telephone interview of Robin Gillespie, Vice President and Deputy General Counsel (Mar. 17, 2006).

[88] *See, e.g.*, Servicing Guide, VIII, Ch 1, Exhibit 4, and Servicing Guide, VII-602.

[89] Servicing Guide, VIII-104.02.

[90] Telephone interview with Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005).

[91] *Id.*

[92] *Id.*

to determine if they were accurately reported.[93] Fannie Mae's NSO does not perform quality assurance of attorney conduct or the legal positions taken in pleadings. Fannie Mae views foreclosure counsel as the attorney of the servicer. The Legal Department has had a view that it can insulate Fannie Mae from responsibility for servicer and attorney misconduct if they are independent contractors and not under Fannie Mae's direct supervision.[94] This approach is under review.[95] Legal positions taken by counsel can have state-wide or national impact, like the standing issue that is currently being litigated in Florida. Since Fannie Mae authorizes servicers to execute legal documents on its behalf[96] and receives the benefit from foreclosures, some plaintiffs may argue that servicers and their counsel are not independent contractors, and therefore may not be insulated from liability for misconduct by servicers or their attorneys.

Fannie Mae believes that lost note affidavits are the servicer's responsibility and can not be effectively reviewed under the current system. Fannie Mae has delegated the execution of lost note affidavits to servicers.[97] It does not believe that it is in a position to make a subjective call as to whether a servicer has lost a note.[98] The party executing the affidavit makes a sworn statement under penalty of perjury as to whether the note is lost, and an attorney advises the executing party regarding the legality of the affidavit.[99] The servicer must comply with all applicable law related to foreclosures.[100] The use of a lost note affidavit also is not

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[93] Attachments to e-mail from Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005).

[94] Interview of Daniel C. Smith, Deputy General Counsel of the Legal Department (Oct. 14, 2005).

[95] Telephone interview of Robin Gillespie, Vice President and Deputy General Counsel (Feb. 1, 2006).

[96] Servicing Guide I-202.05: Execution of Legal Documents.

[97] E-mail from Adam Womack, Servicing Process Manager, Quality Assurance (Dec. 19, 2005).

[98] *Id.*

[99] *Id.*

[100] Servicing Guide, I-306. It states: "We require each Fannie Mae-approved servicer (and any subservicer or third-party originator it uses) to be aware of, and in full compliance with, all federal, state, and local laws (including statutes, regulations, ordinances, administrative rules and orders that have the effect of law, and judicial rulings and

captured as computer data, so reviewing lost note affidavit usage would be manual.[101] Fannie Mae's servicing consultants also do not investigate whether notes are really lost when servicers use lost note affidavits.[102] Fannie Mae views such an investigation as unnecessary because document custodians are responsible for retaining mortgage documents and must bear an expense if they are unable to locate mortgage documents.[103] For these reasons, Fannie Mae believes that servicers are not likely to state that the notes are lost, stolen or missing if they in fact are not.[104] Some in the Legal Department, however, suspect foreclosure attorneys may be taking short cuts by misrepresenting that the notes are lost.

H. Proposal for Changes in Foreclosure Procedures

The Legal Department is formulating a proposal for a new computer system that would permit better communication with foreclosure attorneys and capture information about their conduct.[105] The department recognizes the need for greater communication with attorneys representing Fannie Mae's interests in foreclosures and other proceedings.[106] The new system would permit direct interaction between Fannie Mae attorneys and counsel handling specific cases.[107] Legal positions with broad impact could be coordinated.[108] Lost note affidavits and

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opinions) that apply to any of its origination, selling or servicing practices or other business practices (including the use of technology) that may have a material effect on us. ...."

[101] E-mail from Adam Womack, Servicing Process Manager, Quality Assurance (Dec. 19, 2005).

[102] Telephone interview with Sheila Green, Director of Servicer Management (Dec. 16, 2005).

[103] *Id.*

[104] *Id.*

[105] Telephone Interview with Robin Gillespie, Vice President and Deputy General Counsel (Feb. 1, 2006).

[106] *Id.*

[107] *Id.*

[108] *Id.*

other conduct could be better monitored.[109] The creation and installation of the computer system is a long-term goal, and the system will not be operational in the near future.[110]

The Legal Department also plans to recommend amendments to the Servicing Guide to address the issues raised in the Florida cases, but that too is a long-term project.[111] In the meantime, the Legal Department is working on an interim solution to instruct its RAMN attorneys and large servicers as to how to avoid the issues. [112] It also plans to review samplings of pleadings its attorneys and servicers file to ensure they are complying with Fannie Mae's instructions.[113]

I. Findings on Foreclosure Procedures

We conclude that foreclosure attorneys in Florida are routinely filing false pleadings and affidavits regarding the plaintiff's – MERS or servicers – interest in the proceedings and regarding lost, missing or destroyed promissory notes. The practice could be occurring elsewhere. It is axiomatic that the practice is improper and should be stopped. Fannie Mae has not authorized this unlawful conduct. As a result of the MERS hearings in Florida, Fannie Mae recognizes the issue and is taking action to correct it.

Mr. Lavalle's claim that large numbers of foreclosures – tens of billions of dollars worth – could be unwound as a result of this misconduct likely overstates the risk to Fannie Mae. Courts are unlikely to unwind foreclosures unless borrowers can demonstrate that the foreclosure would not have gone forward with the correct pleadings, which is a difficult burden for most borrowers to meet. Even the Florida judges who were very angry about the false pleadings

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[109] *Id.*

[110] Telephone Interview with Robin Gillespie, Vice President and Deputy General Counsel (Mar. 17, 2006).

[111] *Id.*

[112] *Id.*

[113] *Id.*

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ordered that the foreclosures could go forward with correct pleadings and the proper plaintiff. Civil lawsuits would have a similar burden; the plaintiffs would have to demonstrate damages arising from the false statements. Mr. Lavalle has not presented evidence that the borrowers were improperly placed in default. Nevertheless, the issues Mr. Lavalle raises should be addressed promptly in order to mitigate the risk of exposure to lawsuits and some degree of liability.

III.
TRANSPARENCY ISSUE

A. Mr. Lavalle's Plea for Transparency

A principal source of Mr. Lavalle's concerns is his perception that the mortgage industry is not transparent to homeowners and courts. As the industry has matured, it has become highly complex. Fannie Mae has instituted policies that have made transactions more efficient and less costly but have resulted in borrowers having less access to information about their mortgages. In Mr. Lavalle's view, this development allows Fannie Mae and others in the mortgage industry to hide transactions that should be transparent to borrowers, has contributed to predatory servicing, and has made Fannie Mae's financial statements unreliable.

For instance, Fannie Mae's policy of having promissory notes endorsed in blank, undated and without recourse[114] was intended to reduce significant administrative costs. When notes are endorsed in blank and mortgage assignments are not recorded in land records, however, borrowers cannot identify the chain of owners and servicers. This procedure, Mr. Lavalle contends, hinders borrowers from auditing the trail of charges and payments in order to correct

[114] Selling Guide, IV-204.

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errors.[115] Victims of predatory servicing, Mr. Lavalle also contends, should be entitled to circumvent unscrupulous servicers to pay off their loans directly to the owners.[116]

Mr. Lavalle contends that by creating MERS and United States Foreclosure Network, Fannie Mae has "helped shaped [sic], guide, direct, govern and implement such [predatory or aggressive servicing] practices for a variety of motives."[117] MERS is another innovation designed to add efficiency to the system. It eliminates the need for paper mortgage assignments and the payment of recordation fees when mortgages are transferred.[118] Mr. Lavalle claims, however, that MERS has further hidden the chain of servicers and owners.

Mr. Lavalle proposes that Fannie Mae instruct MERS to open its records for a fee to the public so that borrowers can ascertain who are the servicers, trustees, investors and custodians of their mortgages.[119] He also claims to be obtaining proxies from friends who have substantial shares in Fannie Mae so that they can seek approval from the Board of Directors or shareholders for various corporate resolutions, including one for an investigation of Fannie Mae's relationship with MERS and USFN.[120]

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[115] Telephone interview with Nye Lavalle (Feb. 6, 2006).

[116] Telephone interviews with Nye Lavalle (Nov. 1, 2005 and Feb. 6, 2006).

[117] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

[118] Fannie Mae Announcement 97-0;, MERS is a Reality!, pp. 1, 10.

[119] E-mail dated June 4, 2004, from Nye Lavalle to Mr. Raines, Ms. House, and other undisclosed recipients; E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors; E-mail dated Oct. 14, 2005, from Nye Lavalle to Mark Cymrot.

[120] E-mail dated Feb. 15, 2006, from Mr. Lavalle to Mark Cymrot and Ambika Biggs.

B. Effects of Note Endorsed In Blank

When Fannie Mae purchases mortgages,[121] Fannie Mae requires the lender to endorse the promissory notes "in blank" and without recourse.[122] Promissory notes in this form are bearer instruments that can be negotiated without endorsement.[123] Promissory notes, which establish the obligation to repay the loan, are governed by Article 3 of the Uniform Commercial Code ("UCC"). The sale of promissory notes is also now covered under Revised UCC Article 9.[124] As a result of Fannie Mae's policy of requiring lenders to endorse notes in blank, notes do not contain a series of endorsements that would permit the borrower to identify the chain of ownership. Secondary market transactions, however, do not affect a borrower's payments or other obligations under the mortgage. They also do not necessarily affect the servicer with whom the borrower interacts.

Mortgages are treated differently from promissory notes under the law. Mortgages, which establish the security interest in the home, are governed by UCC Article 9, and the obligation to record the mortgage is governed by state laws that vary from state to state. The purpose of land record laws is to give public notice of liens on real property. These laws do not

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[121] Fannie's Selling Guide defines "Mortgage" as: "Collectively, the security instrument, the note, the title evidence, and all other documents and papers that evidence the debt (including the chattel mortgage, security agreement, and financing statement for a cooperative share loan); an individual secured loan that is sold to us for retention in our portfolio or for inclusion in a pool of mortgages that backs a Fannie Mae-guaranteed mortgage security. The term includes a participation interest where context requires." Selling Guide, Part XIII, Glossary.

[122] Selling Guide, IV-204.

[123] U.C.C. Revised § 3-205(b). It states: "(b) *When indorsed in blank, an instrument becomes payable to bearer* and may be negotiated by transfer of possession alone until specially indorsed." U.C.C. Revised § 3-205(a) defines a special indorsement as one that "identifies a person to whom it makes the instrument payable."

[124] Revised § 9-109. It states: "this article applies to ... a sale of accounts, chattel paper, payment tangibles, *or promissory notes*." § 9-109(a)(3). Former Article 9 did not apply to the sale of promissory notes. "Subsection (a)(3) expands the scope of this Article by including the sale of ... a 'promissory note.'" Revised § 9-109, Official Comment 4.

require and do not provide a mechanism for recording promissory notes.[125] When a lender sells to Fannie Mae a mortgage that is not registered with MERS, the lender or the servicer must prepare a mortgage assignment.[126] If the lender is not the servicer, the lender must assign the mortgage to the servicer and record the assignment in the land records.[127]

Fannie Mae's position is that it does not need to appear in the land records in order to have the benefit of the security provided by the mortgage.[128] UCC§ 9-203(g) and its accompanying comment state that the transfer of an obligation secured by a security interest also transfers the security interest.[129] Thus, the transfer of the promissory note, which is the obligation, also transfers the mortgage, which is the security interest. Once the note is sold to Fannie Mae, the mortgage also transfers, despite the fact that the servicer, lender or MERS' name appears in the land records.

Borrowers thus cannot determine the chain of owners from public records. Under the Servicing Guide, however, borrowers should be able to determine whether Fannie Mae is the beneficial owner of their loan. The Servicing Guide states that the "servicer should freely

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[125] *See* Asset Based Financing: A Transactional Guide, at §9.04[2] (Howard Ruda ed., LexisNexis, Vol. 1 2005), which states: "Typically, [recording] acts require that the *mortgage or deed of trust* be recorded in the district or county where the property is located"); *see also* Black's Law Dictionary 1301 (8th ed. 2004), which defines "recording act" as a "law that establishes the requirements for recording a deed or other property interest and the standards for determining priorities between persons claiming interest in the same property," and defines "recordation" as the "act or process of recording an instrument, such as a deed or mortgage, in a public registry."

[126] Selling Guide, IV-402 states: "For any mortgage that is not registered with MERS, we require the lender to prepare an assignment of the mortgage to Fannie Mae, although the assignment should not be recorded. If the mortgage seller is not going to service the mortgage, the unrecorded assignment to Fannie Mae must be executed by the mortgage servicer."

[127] Selling Guide, IV-403. It states: "When the mortgage seller and the mortgage servicer are not the same entity, we require a recorded intervening assignment from the seller to the servicer—and then an assignment from the servicer to us (or MERS)."

[128] Interview with Daniel C. Smith, Deputy General Counsel (Oct. 14, 2005).

[129] U.C.C. Revised § 9-203(g) states: "The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage or other lien." The Official Comment states that subsection (g) "codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien."

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disclose Fannie Mae's interest in the mortgage in response to a borrower's inquiry (including the name, address, and telephone number of our applicable regional office if the borrower requests this type of information)."[130] Borrowers may not always be able to determine who owns their mortgage, but they should be able to determine if Fannie Mae owns it, if that information is important to them.

C. MERS Impact on Transparency

Prior to the creation of MERS, the borrower could look to the land records to follow the chain of servicers. If a mortgage is registered with MERS, however, MERS is the mortgagee of record. Fannie Mae does not require lenders to register mortgages they sell or service for Fannie Mae with MERS.[131] If a lender registers a mortgage with MERS, it can do so in one of two ways. First, it can originate the mortgage with MERS appearing in the security instrument as the nominee for the beneficiary and its successors and assigns.[132] This is known as MOM, or MERS as Original Mortgagee.[133] Originating the mortgage with MERS as nominee "eliminate[s] the need for a subsequent assignment of the security instrument should the lender sell (or transfer servicing of) the mortgage to another lender that is a member of MERS.[134]

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[130] Servicing Guide, I-311.

[131] Fannie Mae Announcement 97-08, p.1, stating: "Although we will not require lenders to register their Fannie Mae-owned or securitized mortgages with MERS, we expect that many lenders will want to register all of their mortgages with MERS. We encourage all lenders to look into the benefits that MERS offers."

[132] MERS Recommended Foreclosure Procedures, First Edition, p. 4.

[133] MERS Recommended Foreclosure Procedures, First Edition, p. 4.

[134] Selling Guide, IV-103. It states that when a mortgage is originated with MERS as nominee: "the applicable security instrument must be appropriately modified to show MERS as the nominee for the lender, to define and name the originating lender, and to obtain the borrower's acknowledgment of MERS' role in the mortgage transaction ... The lender will be responsible for the accurate and timely preparation and recordation of the security instrument (and must take all reasonable steps to ensure that the information on MERS is updated and accurate at all times)."

Second, if the mortgage already has been originated, the lender can record an assignment of the mortgage to MERS, making MERS the mortgagee of record.[135]

In either case, MERS becomes the mortgagee of record in the county land records.[136] All subsequent transfers of ownership or servicing rights among MERS members are recorded electronically.[137] As long as the loan is sold and transferred to a MERS member, the identity of the record mortgagee never changes during the life of the loan even though the owner and servicer might.[138] If a borrower has not kept historical records of payments, the land records no longer will provide a chain of servicers for the borrower to use to trace problems.

A study of foreclosures in the Chicago, Illinois area found that in 2003, MERS was the most active foreclosing institution in that area.[139] That year MERS started 14.7 percent of all foreclosures.[140] The study found that MERS made it difficult for borrowers to track who owned properties that were foreclosed upon, as well as those entities that may have used abusive practices, by hiding the identities of lenders, servicers or trustees.[141]

D. Reasons for Endorsement and Recording Policies

The purpose of both developments was to reduce paperwork and lower the costs of mortgage administration, which should have the effect of lowering interest rates. If notes

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[135] MERS Recommended Foreclosure Procedures, First Edition, pp. 4-5.

[136] *Id.* at 5. Lenders who sell loans to Fannie Mae may or may not have to assign the mortgage to Fannie Mae depending on whether the mortgage is registered with MERS. *See,* Selling Guide IV, Chapter 4: Assignment of Mortgages.

[137] MERS Recommended Foreclosure Procedures, First Edition, p. 5.

[138] *Id.* at 5. *See also* MERS is a Reality!, p. 2, stating: "Because the mortgagee of record (MERS) [does] not change while the loan is current, there [is] no necessity either to execute or record in the public land records any assignments to reflect the ... sale of the mortgage to an investor, or the transfer of servicing rights."

[139] National Training and Information Center, October 8, 2004, "Preying on Neighborhoods II: Community Partners Turn the Tide Against Predatory Lending," p. 25. The study analyzed foreclosures in Cook, DuPage, Kane, Lake, McHenry and Will counties. *Id.* at 11.

[140] *Id.* at 25.

[141] *Id.*

were endorsed (as they once were), Fannie Mae would incur the considerable administrative cost of endorsements for millions of transactions.[142] MERS was created, in part, to eliminate the need to record mortgage assignments in state land records when servicing rights were transferred. These developments, however, had the secondary effect of making the mortgage markets less transparent for borrowers.

Fannie Mae's policy of having the servicer, lender, or MERS act as the mortgagee of record serves two other purposes. The servicer's duties include protecting Fannie Mae's interest in the mortgaged property.[143] The servicer can better perform when legal notices that may affect Fannie Mae's lien on the property come directly to it.[144] If Fannie Mae were the mortgagee of record, it would have to forward these notices to the servicer, just as MERS must do when it is the mortgagee of record.[145]

Having MERS or the servicer named in the land records also tends to direct complaints to the servicer whose conduct is generally the one being questioned. Borrowers rarely, if ever, need to know the current owner, or chain of owners, of their mortgage. Income streams from mortgages have been fractured and sold as MBS's. In many cases, none of the numerous owners would have the legal right to resolve issues with a servicer. Mr. Lavalle's proposal to allow borrowers to avoid an unscrupulous servicer by paying the owners or trustee is

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[142] *See* U.C.C. Revised § 3-201(b), which states "... if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument *and its indorsement by the holder*. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone." U.C.C. Revised § 3-201(a) states: "'Negotiation' means a transfer of possession, whether voluntary *or involuntary*, of an instrument by a person other than the issuer to a person who thereby becomes its holder."

[143] Servicing Guide, I-202.

[144] *Id.* It states: "To facilitate performance of the servicer's contractual responsibilities to Fannie Mae and the borrower, the servicer ordinarily appears in the land records as the mortgagee. For example, this ensures that the servicer receives legal notices that may impact our lien, such as notices of foreclosure of tax and other liens."

[145] Servicing Guide, III, Chapter 5. When the notices provide enough information for MERS to determine the servicer of the mortgage, MERS forwards the notice to the servicer. When not enough information is available to identify the servicer, MERS electronically notifies all MERS members about the unidentified notice.

unworkable. The owners are too numerous and Fannie Mae does not have facilities to deal directly with the public. In a recent conversation, Mr. Lavalle acknowledged that strict enforcement of servicer obligations would be a better approach to the issue.

E. Disclosures to Borrowers

Fannie Mae has chosen, consistent with its charter, to require servicers to provide information to and assist borrowers with problems rather than interact with borrowers directly. The Servicing Guide III-104 requires servicers to provide borrowers with an annual statement of activity in their account. Servicers also:

> ... must provide a detailed analysis of all transactions relating to a borrower's payments or escrow deposit account whenever the borrower requests it.[146]

Servicers also must "provide borrowers with assistance when it is requested" and "have effective processes to promptly address borrower inquiries (relating to both current and delinquent loans) and provide timely payoff quotes."[147] The Guide also instructs servicers to inform borrowers that Fannie Mae is the owner of their notes if they ask.[148]

When servicing rights are transferred, Fannie Mae requires the servicers to notify and provide information to borrowers about the transfer.[149] RESPA also requires servicers of "federally related mortgage loans" to inform borrowers of any assignment, sale or transfer of the servicing of a loan.[150]

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[146] *Id.*

[147] Servicing Guide, I-202. It states: "As a general matter, servicers should have sufficient properly trained staff, and adequate controls and quality assurance procedures in place, to carry out all aspects of their servicing duties; to protect against fraud, misrepresentation, or negligence by any parties involved in the mortgage servicing processes; to protect our investment in the security properties . . . ."

[148] Servicing Guide I-311.

[149] Servicing Guide, I-205.04.

[150] 12 U.S.C § 2605.

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Although Fannie ordinarily does not have direct contact with borrowers, it has established channels for borrowers to report suspected cases of mortgage fraud.[151] Borrowers can contact Fannie Mae via a toll-free telephone number or by e-mail.[152] Fannie Mae's procedures for investigating these tips are detailed in the section on fraud investigations and reporting.

F. Findings Regarding Transparency

Mr. Lavalle's complaint about transparency is the natural consequence of mortgage markets becoming more complex and fractured. The requirement to have notes endorsed in blank and the creation of MERS are designed to add efficiency to the mortgage markets and reduce costs, which should benefit homeowners with lower interest rates and more choices. These developments, however, have made the system less transparent.

Mr. Lavalle complains that a lack of transparency has made it easier for predatory servicers to flourish. Fannie Mae has addressed this issue by requiring servicers to disclose information to borrowers and through other enforcement efforts detailed in the predatory servicing section. These disclosures respond to Mr. Lavalle's proposal that borrowers have access to the MERS' database for a fee; they should be able to get relevant information from the servicers. The borrowers should have ready access to information about their payments, escrows, fees and other relevant information concerning their mortgages.

Mr. Lavalle's proposed solution that borrowers be given the option to conduct transactions directly with note owners or Fannie Mae is impractical and not consistent with Fannie Mae's mission. Ownership interests in mortgage income streams have been fractured due

[151] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule; Single-Family Anti-Fraud Protocols and Procedures, p. 6.

[152] *Id.*

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to the advent of MBS's. No single owner would have authority to bind others, and no mechanism exists for owners to resolve servicing disputes. Fannie Mae, as owner or trustee for MBS's is not intended to, and not capable of, interacting directly with borrowers; it operates in a secondary market in which its customers are lenders and servicers.

Mr. Lavalle has provided examples of situations in which borrowers have had difficulty obtaining information, even in litigation. We have not been able to examine the full context of these problems. As discussed below, Fannie Mae reviews certain servicer conduct and has taken steps to prevent or uncover predatory servicing practices. As Mr. Lavalle recently acknowledged, the better approach is for Fannie Mae to mandate that servicers be transparent with borrowers – which it already does – and to enforce these requirements and those prohibiting predatory lending and servicing practices – which it also appears to do.

IV.
PROMISSORY NOTE POLICIES

A. Mr. Lavalle's Concerns

Mr. Lavalle expresses concern about two Fannie Mae policies regarding the handling of promissory notes: (1) notes are required to be endorsed in blank, undated and without recourse,[153] and (2) original notes are not consistently returned to the borrower stamped "cancelled" and "paid in full."[154] Mr. Lavalle questions whether Fannie Mae has adequate procedures in place to keep track of 15 million promissory notes that it has in its possession or is held for its account.[155] Mr. Lavalle claims that the endorsement-in-blank policy leads to trillions

[153] E-mail dated Dec. 19, 2003 from Nye Lavalle to then-Fannie Chairman and Chief Executive Officer Franklin Raines and other individuals.

[154] E-mail dated July 22, 2005, from Nye Lavalle to Ms. House, Mr. Mudd, and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff, and others.

[155] E-mail dated Dec. 19, 2003, from Nye Lavalle to then-Fannie Mae Chairman and Chief Executive Officer Franklin Raines and other individuals; E-mail dated July 22, 2005, from Nye Lavalle to Ms. House, Mr. Mudd, and

of dollars of missing or lost negotiable paper.[156] Mr. Lavalle bases his claim that the problem is widespread by extrapolating from routine filing of lost note affidavits in Florida foreclosure proceedings.[157] He acknowledges that every entity operating in the secondary mortgage market has the same policy.[158] According to his calculations, about $6 trillion worth of bearer paper exists due to this practice.[159] Since these notes are negotiable instruments, Mr. Lavalle contends borrowers face dire consequences from their mishandling.[160] A holder in due course, for instance, can recover even when the maker has defenses or has paid the note in full.[161]

Mr. Lavalle also criticizes Fannie Mae's policies regarding the return of original notes upon pay off. Fannie Mae's policies allegedly are having an adverse impact on borrowers and on the value of Fannie Mae's mortgages and mortgage-backed securities. Original promissory notes are not routinely returned to borrowers stamped "cancelled" and "paid in full" when they pay off their loans. He feels that satisfactions or lien releases, which are now permitted under state laws, do not adequately protect borrowers should their original promissory notes end up in the wrong hands.[162] Mr. Lavalle claims this practice leaves borrowers at risk for years after they have paid off the note.[163] Mr. Lavalle has supplied us with cases of borrowers

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Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff, and others.

[156] Telephone interview with Mr. Lavalle (Nov. 1, 2005).

[157] Telephone Interview with Mr. Lavalle (Nov. 23, 2005).

[158] Telephone interview with Mr. Lavalle (Nov. 1, 2005).

[159] *Id.*

[160] *Id. See also* Benny L. Kass, *Lost Mortgage Documents May Cause Future Problems*, Realty Times, Sept. 13, 2004, available at http://realtytimes.com/rtcpages/20040913_lostdocs.htm.

[161] U.C.C. Revised §§ 3-305(b) and 3-601.

[162] Telephone interview with Mr. Lavalle (Nov. 1, 2005).

[163] *Id.*

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subjected to claims by multiple lenders alleging ownership of the same notes.[164] Mr. Lavalle proposes that lenders be required to return the original promissory notes stamped "paid in full" with each pay off. Mr. Lavalle fears that if the notes are mishandled, borrowers could bring class action lawsuits, exposing Fannie Mae to great liability.

B. Borrower's Risk to a Holder in Due Course

The risk Mr. Lavalle perceives from lost or mishandled notes arises from the rights given a holder in due course by the UCC. A borrower can be required to pay a note twice – even one that is lost or stolen – if the note comes into the hands of a holder in due course. Under UCC Article III, a maker of a note (*i.e.*, the borrower) is "discharged" of liability under the note once payment has been made in accordance with the note.[165] If, however, the party who comes to possess the note is a holder in due course without notice of the discharge, the discharge is not effective against that party.[166] Generally speaking, a holder in due course is a good faith purchaser of a note for value.[167] An individual who finds or even steals a promissory note endorsed in blank can become a person entitled to enforce the promissory note.[168] Against a person entitled to enforce, the borrower can assert defenses, such as the note has already been

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[164] *See First Union Nat'l Bank v. Hufford*. 767 N.E.2d 1206(Ohio Ct. App. 2001); E-mail from Nye Lavalle to Mark Cymrot and Ambika Biggs, containing postings by individuals claiming there were multiple foreclosures on the same property (Nov. 29, 2005). *See also* E-mail attachments from Carl Erickson, which include an allegedly fraudulent promissory note (Nov. 30, 2005). Mr. Erickson claims that two different companies – Freddie Mac and the Charles F. Curry Company – claimed to be the owner of the note at the same time. Mr. Erickson has communicated with Mr. Lavalle, as is evidenced in the e-mail.

[165] U.C.C. Revised § 3-602(a). It states: "an instrument is paid to the extent payment is made by or on behalf of a party obliged to pay the instrument, and to a person entitled to enforce the instrument. To the extent of the payment, the obligation of the party obliged to pay the instrument is discharged ..."

[166] U.C.C. Revised § 3-601(b). It states: "Discharge of the obligation of a party is not effective against a person acquiring rights of a holder in due course of the instrument without notice of the discharge."

[167] U.C.C. Revised §§ 3-302.

[168] U.C.C. Revised § 3-205, Comment 2; U.C.C. Revised § 3-301, Comment.

paid.[169] If, however, the lost or stolen note is transferred to a holder in due course, the note can be enforced without regard to many of the borrower's defenses, including discharge.[170]

The borrower is, thus, at risk to paying twice if the original promissory note is not properly protected.[171] The borrower would have the expensive and unenviable task of trying to collect from the custodian that was negligent in losing the note, from the servicer that accepted payments, or from others responsible for the predicament.

C. Fannie Mae's Herndon Custody Facility

Fannie Mae's mortgage documents – including promissory notes - are stored in one of three places: Fannie Mae's document delivery facility in Herndon, Virginia; in the possession of an independent custody agent; or in the possession of the servicer, acting as a custody agent.[172] The party responsible for physical possession of the mortgage documents, called custody documents,[173] may vary depending on whether Fannie Mae purchases the

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[169] *See* U.C.C. Revised § 3-302, Comment 3, which states: "Discharge is effective against anybody except a person having rights of a holder in due course who took the instrument without notice of the discharge." Section 3-305(a) provides other defenses.

[170] U.C.C. Revised § 3-601(b). It states: "Discharge of the obligation of a party is not effective against a person acquiring rights of a holder in due course of the instrument without notice of the discharge." In cases involving lost note affidavits, courts have addressed Mr. Lavalle's concern that a subsequent holder will seek to recover against a borrower. *See McKay v. Capital Resources Co.*, 940 S.W.2d 869, 871 (Ark. 1997)(reversing a foreclosure decree in which the foreclosing party only produced a photocopy of the promissory note because the borrower may have been subjected to double liability if the holder of the original note brought a claim); *Shores v. First Florida Resource Corp.*, 267 So. 2d 696 (Fla. Dist. Ct. App. 1972) (in an action for reestablishment of a lost note, the court held that evidence that the note and mortgage had not been assigned was inadequate because the borrowers were entitled to assurance that future holders would not sue them on the instruments); *Resolution Trust Corp. v. First Federal Savings Banks of Diamondsville*, 36 F.3d 972 (10th Cir. 1994) (holding that the debtor was adequately protected by the foreclosing party's agreement to indemnify the debtor for any liability arising from a claim by a person who may become a holder of the lost note).

[171] Notice of discharge does not prevent holder in due course status. *See* Official Comment to U.C.C. § 3-601, stating: "Notice of discharge is not treated as notice of a defense that prevents holder in due course status." However, if the holder in due course had notice of discharge when holder in due course status was established, discharge is effective against the holder in due course. *Id.*

[172] Interview with Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005). *See also* Selling Guide, I-403.

[173] Generally speaking, for portfolio mortgages, these custody documents "consist of the *original mortgage notes*" and other important mortgage documents. Selling Guide, I-403.

mortgage for its portfolio or is a trustee for an MBS pool. Fannie Mae's document delivery facility generally maintains custody of the mortgage documents for its portfolio mortgages,[174] certifying and holding 67 percent of all Fannie Mae portfolios loans certified in 2005.[175] A lender-designated document custodian, which can be the lender, a third-party document custodian, or Fannie Mae's document delivery facility, generally maintains control over MBS custody documents.[176] Fannie Mae certified and held about 6.3 percent of Fannie Mae MBS loans that were certified in 2005.[177]

Of the approximately 15 million Fannie Mae loans (portfolio and MBS), the Herndon facility maintains custody over approximately 2 million, or 13 percent.[178] Each month, Fannie Mae receives and releases the mortgage documents for about 40,000 mortgages, although the numbers can vary considerably.[179] When a mortgage arrives at Fannie Mae's document custody facility for purchase, the custody documents undergo a certification process, during which Fannie Mae employees ensure that the mortgage documents are legally enforceable and that the information the lender submitted regarding the mortgage corresponds with the information recorded on the promissory note.[180] If the mortgage is certified, the promissory note

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[174] Selling Guide, I-403. It states: "The only exceptions to this involve some mortgages we agree to purchase under the terms of a negotiated contract that permits the lender to designate another document custodian and participation pool mortgages we purchased under commitments executed prior to 10/31/91, which permitted the mortgage servicer or the participating lender to retain the custody documents."

[175] *See* Certification chart, included in Letter from Debra Thompson, Director, Asset Acquisitions & Custody, to Mark Cymrot (Jan. 26, 2006).

[176] *See* Selling Guide, I-403. It states: "The only exception to this involves some participation interests in MBS pools that were issued under contracts executed prior to 10/31/91 ..."

[177] *See* Certification chart, included in Letter from Debra Thompson, Director, Asset Acquisitions & Custody, to Mark Cymrot (Jan. 26, 2006).

[178] *See* Vault Percentage chart, included in Letter from Debra Thompson, Director, Asset Acquisitions & Custody, to Mark Cymrot (Jan. 26, 2006).

[179] Interview of Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005).

[180] During the certification process, Fannie Mae employees ensure that there are no breaks in the chain of endorsement from the originating lender to Fannie Mae, that the seller was a holder in due course of the promissory

and other mortgage documents are placed in a vault and remain there until either: (1) the lender requests Fannie Mae to return the promissory note; (2) the lender reports the note as liquidated;[181] or (3) the lender wants the documents to be transferred to another document custodian, which can occur when servicing rights are transferred.[182]

Thirteen jurisdictions require an individual to have possession of the original promissory note in order to take certain legal actions, including foreclosure.[183] Fannie Mae returns the notes to lenders in these jurisdictions, referred to as the Original Notes States. Fannie Mae also returns notes to lenders that have informed Fannie Mae that they always want the notes returned after pay off.[184] Fannie Mae does not mark notes "cancelled" when it returns them to servicers.[185] In addition, if a lender wants Fannie Mae to return a note because it is initiating foreclosure actions, the lender can request it from Fannie Mae through the Loan Document Request System ("LDRS"), which is an electronic system through which lenders request and Fannie Mae sends documents.[186]

If a note is not from an Original Notes State and the lender does not request its return, Fannie Mae destroys the note after the servicer informs it that the loan has been

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note, and that the promissory note is endorsed in blank. In addition, employees review certain information, such as the interest rate, property address, original note rate, first payment due date, principal and interest constant, and unpaid principal balance, to ensure that the information submitted by the lender corresponds to the information recorded on the promissory notes.

[181] Payoffs, repurchases, assignments, deeds-in-lieu, and foreclosures are categorized as liquidation transactions. Servicing Guide, X-601.

[182] Interview of Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005).

[183] The jurisdictions are: California, Connecticut, Colorado, Florida, Massachusetts, Michigan, New Jersey, New York, Pennsylvania, Texas, Virginia, Washington, and Puerto Rico.

[184] These lenders are: Sky Financial, Bank of America, First Merit, and Whatcom Educational Credit Union.

[185] Telephone Interview with Debra Thompson, Director, Asset Acquisitions and Custody (March 3, 2006).

[186] Servicing Guide, VIII-102.

liquidated.[187] Lenders report account activity for the mortgages monthly through an electronic system called LASER.[188] Fannie Mae examines these reports and determines which loans have been liquidated.[189] In order to provide for mistakes in reporting, Fannie Mae leaves a lag time between when lenders indicate that a loan has been liquidated and when the promissory note is shredded.[190] Fannie Mae employees pull the promissory notes from the vaults 90 days after lenders report the loan liquidated. The note is stored for 30 days before it is sent to the contractor for shredding.[191] Approximately 60 percent of the mortgage documents are returned to lenders and 40 percent are destroyed.[192]

D. Other Certified Custodians

Other than its own facilities, Fannie Mae certifies 58 active document custodians.[193] Fannie Mae has additional inactive custodians that hold mortgage documents for Fannie Mae, but they no longer certify documents for new loans.[194] Document custodians must comply with Fannie Mae's procedures.[195] In order to be a document custodian, the custodial institution must be a regulated financial institution or a subsidiary and meet certain eligibility

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[187] Telephone Interview with Debra Thompson, Director, Asset Acquisitions and Custody (March 3, 2006). Servicing Guide, 1-403.03, however, states: "The document delivery facility will automatically return to the servicer any custody documents it is holding for a portfolio mortgage and MBS pool within 60 to 90 days after the servicer reports a mortgage payoff or repurchase, the acceptance of a deed-in-lieu, or the completion of foreclosure proceedings to us through *LASER*." This procedure has since been updated, but the change is not reflected in the Servicing Guide.

[188] *See* Servicing Guide, X: LASER Reporting System.

[189] Interview of Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005).

[190] *Id.*

[191] *Id.*

[192] *Id.*

[193] Telephone interview with Debra Thompson, Director, Asset Acquisitions and Custody (Mar. 3, 2006).

[194] *Id.*

[195] Guidelines for Document Custodians, Introduction (stating "Fannie Mae requires that certain documents relating to mortgages in MBS pools be held by custodial institutions (called document custodians) that meet the eligibility criteria set out in the Selling and Servicing Guides.").

criteria that are set forth in the Selling and Servicing Guides and the Guidelines for Document Custodians.[196] These criteria include having the capabilities to track the receipt and release of documents and the physical location of documents, and maintaining secure storage facilities that have controls to ensure the security of custody documents.[197] The custodian also must install the MORNET Custodian Certification System, an electronic service that enables it to transmit MBS pool certifications. Each document custodian must subscribe to Fannie Mae's Selling, Servicing, and Forms Guides to ensure that all are aware of Fannie Mae's latest policies and procedures."[198] Lenders must have a Custodial Agreement with one of the certified custodians for all MBS pools they deliver to Fannie.[199] The promissory note is one of the custody documents the custodian holds.[200]

When the document custodian receives documents from the lender, it must review and certify them in the same manner as Fannie Mae's Herndon facility.[201] The lender electronically submits to the custodian a Schedule of Mortgages, which includes data about the individual mortgages in each MBS pool for which the custodian will maintain documents.[202] The custodian must compare the information recorded in the Schedule of Mortgages to the information contained on the related notes to ensure it is the same.[203] If the document custodian

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[196] *See id.*; Guidelines for Document Custodians, Eligibility Criteria for Third-Party Document Custodian; Guidelines for Document Custodians, Eligibility Criteria for Lending [sic] Acting as Own Document Custodian.

[197] Guidelines for Document Custodians, Eligibility Criteria for Third-Party Document Custodian.

[198] Guidelines for Document Custodians, Introduction.

[199] *Id.*

[200] Guidelines for Document Custodians, Custody Documents. *See also* Selling Guide, VI-302.01, for a similar list of items that a lender that creates an MBS pool must send to the document custodian for each mortgage in the pool.

[201] Guidelines for Document Custodians, Introduction.

[202] Guidelines for Document Custodians, Documentation Review, and Certification, Schedule of Mortgages (Form 2005).

[203] *Id.*

receives all the required documents and determines that they contain the correct information and are consistent with Fannie Mae's requirements, it sends an electronic certification of the MBS pool to Fannie Mae.[204]

After the custodian has certified the MBS pool, it "must exercise control over all documents that are retained in its custody."[205] If a lender transfers documents to a different custodian, the new custodian must recertify the MBS pool, by indicating that it has received all required documents and that any new documents required in connection with the transfer satisfy Fannie Mae's requirements.[206]

The Guidelines for Document Custodians also state that "[o]nce the documents related to an MBS pool are delivered to the document custodian, the note and, if applicable, the assignment of the mortgage to Fannie Mae must remain in the custodian's possession at all times, unless the lender needs to obtain documents to perform a specific servicing function (such as the initiation of foreclosure proceedings or satisfaction of a mortgage that has been paid-in-full)."[207] The lender must submit a *Request for Release/Return of Documents* form to obtain the documents from the custodian,[208] and if the documents are released on a temporary basis, the lender must return the documents as soon as it no longer needs them.[209] When an MBS pool has been liquidated, meaning that all the individual mortgages in the pool have been liquidated, the

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[204] Guidelines for Document Custodians, Documentation Review, and Certification, Document Custodian's Certification. This electronic certification is sent via the MORNET Custodian Certification System.

[205] Guidelines for Document Custodians, Introduction.

[206] *Id.*

[207] Guidelines for Document Custodians, Request for Release/Return of Documents (Form 2009).

[208] *Id.*

[209] *Id.*

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lender should send a written request within 30 days of liquidation of the MBS pool to the document custodian to return any remaining documents to the lender.[210]

The current Custodian Guidelines, however, do not have any provision for centralized reporting of lost notes, or a procedure for requiring the custodian or the servicer to report the missing note to the borrower.

E. Fannie Mae's Internal Audits and Custodian Reviews

Fannie Mae's own document custodian facility undergoes periodic internal audits by Fannie Mae's Audit Department to ensure compliance with these procedures. In the past, internal auditors had not focused specifically on the document custodian facility, but had reviewed it while auditing other areas of Fannie Mae.[211] Currently, a more vigorous internal audit is in progress.[212] Internal auditors are reviewing Fannie Mae's procedures regarding certification, access to the vault, and inventory control, which includes note retention, return, and destruction processes.[213] So far, they have found that Fannie Mae management already had identified and taken steps to correct most of the issues they discovered during the audit.[214] They anticipate completing the audit by mid-March 2006.[215]

Fannie Mae recently instituted reviews of the 58 certified custodians.[216] Fannie Mae employees conducted walk-throughs at document custodians' facilities to examine their

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[210] Guidelines for Document Custodians, Liquidated MBS Pools. It further states: "For the most part, the custodian will already have released the documents based on receipt of a *Request for Release/Return of Documents* (Form 2009). The custodian does not need to request submission of a Form 2009 for any remaining documents – the lender's written request will be sufficient justification for the document custodian to close out its records for the pool."

[211] Telephone interview with Curtis Doss, Audit Director for the Guarantee Fee Division (Mar. 3, 2006).

[212] *Id.*

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] Interview with Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005).

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procedures and processes. They also selected pools and loans to review to determine if there are any errors in their certification procedures. Fannie Mae conducted reviews of six custodian facilities in 2005, and plans to visit all 58 during 2006.[217] The 2005 reviews found generally good compliance with the required custodial procedures. Fannie Mae is in the process of developing guidelines to standardize the certification process.

Fannie Mae's custodian reviews focus principally on the certification process, which tests the information about mortgages in Fannie Mae's computer system. The reviews do not specifically test whether the custodian is maintaining proper control over promissory notes.

We have not found evidence that Fannie Mae's custodial procedures are inadequate or that notes are regularly being lost or stolen. Other than pointing to the filing of numerous lost note affidavits, which appear to be indicative of improper pleading rather than actual lost notes, Mr. Lavalle has not presented evidence that notes are regularly being mishandled. Fannie Mae's document custodian prepared lost note affidavits as follows:

2003	97
2004	183
2005	108.[218]

Fannie Mae's original promissory notes do not appear to be regularly lost or stolen in a volume that would present a serious financial problem for Fannie Mae. Every lost note obviously is important because it puts a borrower at risk. We have found no evidence, however, that any lost notes have been misused to the detriment of a borrower.

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[217] Interviews with Debra Thompson, Director, Asset Acquisitions, and Custody (Nov. 8, 2005, and Feb. 17, 2006); and interview with John Gang, Vice President, Asset Acquisitions, and Custody (Dec. 8, 2005).

[218] E-mail from Debra Thompson, Director, Asset Acquisitions, and Custody to Mark Cymrot (Feb. 21, 2006); Letter from Ms. Thompson to Mr. Cymrot (Jan. 30, 2006).

F. Satisfactions and Lien Releases

Mr. Lavalle would like every original promissory note returned to the borrower once it is discharged in order to mitigate the risk that it could get into the wrong hands. Fannie Mae's policy is to require servicers to satisfy a mortgage and release the lien in a timely manner and in accordance with the applicable state law.[219] The servicers also must return the cancelled note to borrowers if required by state law or the borrower specifically requests the note.[220] In other cases, the servicer either can return the documents to the borrower or retain them.[221]

In our view, Fannie Mae can rely upon the dictates of state law. State legislators presumably evaluated the risks Mr. Lavalle has expressed and determined that loan satisfactions and lien releases are adequate to protect borrowers and a reasonable trade off for the added efficiencies to the mortgage system.

G. Findings Regarding Promissory Notes

While Mr. Lavalle's concern has a theoretical legal basis, we have not found evidence that large volumes of promissory notes are being mishandled. He bases his assertion on the routine filing of lost note affidavits. The affidavits, however, appear to be inaccurate, rather than the notes lost. Fannie Mae has policies for its own in-house custodian and the 58 custodians

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[219] Servicing Guide, VI-103. It states: "We expect a servicer to take all actions necessary to satisfy a mortgage and release the lien in a timely manner . . . . Procedures for satisfying the mortgage will vary depending on whether or not we are the owner of record for the mortgage; the party holding the custody documents; and whether the mortgage is a portfolio mortgage or an MBS pool mortgage. Regardless of the procedure used, the servicer has the ultimate responsibility for having the lien released in a timely manner." If Fannie Mae is the owner of record, it must execute any required release or satisfaction documents, unless it has granted a limited power of attorney to the servicer. Servicing Guide, VI-103.01. If Fannie Mae is not the owner of record, the servicer must execute the release or satisfactions documents in its or MERS' name. Servicing Guide, VI-103.02. The servicer also must submit forms to either Fannie Mae or the document custodian requesting the custody documents. *See* Servicing Guide, VI-103.01 and VI-103.02.

[220] *Id.* It states: "Once the required release or satisfaction documents are executed and the mortgage note is canceled, the servicer must immediately send the canceled documents to the borrower if state law requires such action or the borrower specifically requests the return of the documents."

[221] *Id.* (stating "In other instances [when state law does not require the return of the documents and the borrower has not requested them], the servicer may either return the documents to the borrower or retain them (as long as they are not destroyed until after the retention period required by applicable law).")

it has certified that they seek to protect the mortgage documents. We have found no evidence suggesting that these procedures are ineffective.

With respect to the return of original promissory notes, Fannie Mae is following state law. In the jurisdictions in which original notes must be returned, they are. Fannie Mae also responds to requests from lenders and borrowers to return original notes. If borrowers want their original notes, they can ask for them. In our view, Fannie Mae can reasonably rely upon state law. The risk that Mr. Lavalle identifies has been evaluated by state legislatures which have established rules for mortgages within their states.

V.
PREDATORY SERVICING

A. Mr. Lavalle's Concerns

Mr. Lavalle alleges that Fannie Mae has been instrumental in creating a system in which predatory servicing flourishes. He claims to have coined the term "predatory servicing"[222] to describe practices and schemes that mortgage servicers use to defraud borrowers.[223] Mr. Lavalle perceives servicing problems as more pervasive than Fannie Mae officials and suggests that Fannie Mae should do more to protect borrowers, including having direct interaction with borrowers when problems arise. He objects to a perceived lack of oversight of servicers by Fannie Mae and to Fannie Mae's role in creating and operating MERS.

Mr. Lavalle believes that Fannie Mae and Freddie Mac "are responsible for the activities of sellers and more importantly, servicers" and views Fannie Mae as a quasi-

[222] E-mail dated Oct. 2, 2005, from Nye Lavalle to Mark Cymrot. Mr. Lavalle claims to have coined the phrase in the late 1990s.

[223] *See, e.g.*, report by Nye Lavalle entitled "Predatory Grizzly 'Bear' Attacks Innocent, Elderly, Poor, Minorities, Disabled & Disadvantaged!", pp. 4-11.

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regulator.[224] He claims a seller or servicer is practically required to be Fannie Mae-approved in order to do business.[225] Fannie Mae also establishes how the servicers conduct their businesses, and Fannie Mae places employees in servicers' offices to oversee their servicing operations.[226] He also claims that servicers are Fannie Mae's agents, and therefore, Fannie Mae can be held liable for its servicers' inappropriate actions. Fannie Mae's employees make the decision or authorize the servicers' recommendation "to make the hit" – that is, deciding whether to foreclose.[227]

Since Fannie Mae plays such a central role in the mortgage industry, it can and should take the lead in ending predatory servicing practices, he argues.[228] In Mr. Lavalle's opinion, Fannie Mae should institute good servicing guidelines because the mortgage industry follows Fannie Mae and Freddie Mac's lead "as a matter of course in doing business."[229] For instance, he has proposed a joint effort to review servicer performance, and he wants Fannie Mae to mandate a set of "best practices" based on a set of practices that Fairbanks Capital Corp. agreed to in its 2003 consent order with the United States.[230]

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[224] E-mail dated Oct. 14, 2005, from Nye Lavalle to Mark Cymrot.

[225] *Id.*

[226] Telephone interview with Mr. Lavalle (Nov. 1, 2005). *See* "Current Issues: Overview of Credit Risk Management at Fannie Mae, June 19, 2002, available at www.fanniemae.com, stating: "Fannie Mae employs 44 servicing consultants," who work as on-site consultants at our largest loan servicers, helping them manage problem loans on a case-by-case basis with judgment and speed. Working with our mortgage servicers, Fannie Mae has redefined the traditional collection rules to focus lender resources and attention on those loans most at risk."

[227] Telephone interview with Mr. Lavalle (Nov. 1, 2005).

[228] E-mail dated Oct. 14, 2005, from Nye Lavalle to Mark Cymrot.

[229] E-mail dated June 4, 2004 from Mr. Lavalle to Mr. Raines, Ms. House, and other undisclosed recipients requesting Fannie Mae establish a National Compliance Center and institute mortgage servicing best practices standards that he recommended. He also requested that Fannie Mae not conduct any business with any companies found to be using predatory servicing practices. E-mail dated Oct. 14, 2005, from Nye Lavalle to Mark Cymrot.

[230] *U.S. v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Oct. 6, 2003) (order preliminarily approving stipulated final judgment and order as to Fairbanks Capital Corp. and Fairbanks Capital Holding Corp.)In that case, the Federal Trade Commission ("FTC") and the Department of Housing and Urban Development ("HUD"), accused Fairbanks of violating the Federal Trade Commission Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting

He also asserts that borrowers are not informed of fraud by loan originators and servicers that Fannie Mae discovers in its due diligence and quality control processes.[231] Fannie Mae may report its findings to MARI, an industry database, but borrowers are not told.[232] Mr. Lavalle believes that Fannie Mae has an ethical obligation to inform borrowers when it uncovers fraud.[233]

Mr. Lavalle asserts that Fannie Mae has a policy of labeling mortgages that are unsellable as "scratch and dent" after rejecting them for purchase.[234] The loans are then sold to "special servicers," such as EMC Mortgage, Litton Loan Servicing, Ocwen, and Select Portfolio Servicing ("SPS")(formerly Fairbanks Capital Corp.), which aggressively service the loans into foreclosure or bankruptcy, he claims.[235] Mr. Lavalle alleges that in the foreclosure process, Fannie Mae transfers servicing rights to aggressive servicers.[236]

Mr. Lavalle refers to these special servicers as "the toxic waste dump."[237] He asserts that these companies defraud borrowers, by such schemes as not crediting a borrower for payments, misapplying payments, and placing unnecessary force-placed insurance on borrowers' accounts and others.[238] When borrowers complain about these practices, which the mortgage

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Act, and the Real Estate Settlement Procedures Act ("RESPA"). The case was settled by a consent decree that mandated certain business practices to correct the alleged abuses.

[231] E-mail dated June 22, 2005 from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

[232] *Id.*

[233] *Id.*

[234] Telephone interview with Mr. Lavalle (Nov. 1, 2005).

[235] E-mail from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors (July 22, 2005); *see also* E-mail from Nye Lavalle to Mark Cymrot (Oct. 7, 2005).

[236] Telephone interview with Nye Lavalle (Dec. 14, 2005).

[237] July 22, 2005, e-mail from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors

[238] *See, e.g.*, report by Nye Lavalle entitled "Predatory Grizzly 'Bear' Attacks Innocent, Elderly, Poor, Minorities, Disabled & Disadvantaged!", pp. 4-11.

servicers claim are just mistakes, their mortgages are not reamortized to adjust payments and interest assessments, he claims.[239] Mr. Lavalle suggests that Fannie Mae has an obligation to inform the borrowers their loans are going to be subject to aggressive servicers.

As a Fannie Mae shareholder, Mr. Lavalle is concerned about criminal and civil liability that Fannie Mae could face for its servicers' misconduct.[240]

B. Current Servicer Rules and Procedures

Fannie Mae has contracts with about 1,500 active servicers, either original lenders or independent servicers.[241] A servicer must first be approved before servicing Fannie Mae loans. If a servicer assigns its responsibility to service a loan to another servicer, it must first get approval from Fannie Mae.[242]

For a traditional servicer to be approved, the servicer must meet minimum eligibility and capability requirements.[243] For instance, it must have experience in selling and servicing mortgages, have knowledge of Fannie Mae's policies and practices, and have post-closing quality control methods in place.[244] In addition, Fannie Mae conducts a MARI check on the seller/servicer and LexisNexis background checks on the seller/servicer's principals.[245]

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[239] E-mail dated Oct. 7, 2005, from Nye Lavalle to Mark Cymrot.

[240] E-mail dated July 22, 2005, from Nye Lavalle to Ms. House, Fannie Mae President, and CEO Daniel Mudd, and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff, and others.

[241] E-mail dated Mar. 1, 2006 with attachment of a chart of the Servicer Counts for Year-Ends 2002-2004, from Marianne Sullivan, Senior Vice President, Credit Loss Management. There was an average of 1,532 servicers at year-end in 2002, 2003, and 2004.

[242] Mortgage Selling and Servicing Contract, VII; *see also* Servicing Guide, I-205.

[243] Interview with Robert Sanborn, Vice President, National Servicing Organization (Nov. 15, 2005).

[244] *Id.*

[245] Interview with Mercy Jimenez, Senior Vice President of the National Business Center (Nov. 7, 2005).

MARI, Mortgage Asset Research Institute, Inc., provides information services for the mortgage and financial services industries.[246]

Approved processors of less traditional loans, referred to as non-traditional servicers, are subjected to a more rigorous approval process.[247] Fannie Mae employees visit the servicers' facility and observe its selling and servicing practices to determine if they comply with Fannie Mae's.[248] Fannie Mae has approved only 46 non-traditional servicers, but 13 of those do not service any Fannie Mae loans.[249] Non-traditional servicing is not synonymous with subprime servicing, and non-traditional servicers do not necessarily service loans with a higher risk of default than most loans.[250] For instance, reverse mortgages and eChannel loans, which allow borrowers with good credit ratings to streamline the home buying process, are considered non-traditional,[251]

Nine large servicers service 70 percent of Fannie Mae's loan assets, and 40 servicers service 85 percent of Fannie Mae's loan assets.[252] Mr. Lavalle has specifically complained about the practices of four servicers – EMC Mortgage, Litton Loan Servicing, Ocwen Financial Corporation, and Select Portfolio Servicing ("SPS"), formerly Fairbanks Capital Corp. From 2002 through 2004, these entities combined serviced less than one percent

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[246] MARI Overview, available at http://www.mari-inc.com/about.html.

[247] Interview with Robert Sanborn, Vice President, National Servicing Organization (Nov. 15, 2005).

[248] *Id.*

[249] Telephone Interview, Rick Bauerband, Director of Non-Traditional Servicing (Mar. 14, 2006). These approved servicers may originate loans and then transfer them to other servicers, but they are approved to service Fannie Mae loans.

[250] *Id.*

[251] *Id.*

[252] Interview with Robert Sanborn, Vice President, National Servicing Organization (Nov. 15, 2005).

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of all the loans Fannie Mae owned.[253] They also serviced less than one percent of the unpaid principal balances for loans Fannie Mae owned.[254]

After approval, all servicers must sign Fannie Mae's Mortgage Selling and Servicing Contract that establishes the basic legal relationship.[255] Fannie Mae also publishes a Selling Guide and a Servicing Guide to keep lenders informed of its policies. Under the contract, the mortgages must be sold and serviced in accordance with the Guides.[256] The Servicing Guide allows for variants which are subject to negotiation between Fannie Mae and the servicer.[257]

The Servicing Guide provides "broad parameters" for servicers.[258] Fannie Mae takes the position that servicers are independent contractors, and not agents, assignees or representatives of Fannie Mae.[259] The Servicing Guide thus gives servicers considerable discretion about how to conduct their businesses. The Guide states:

> ... most of the policies and standards described in this *Guide* are intended to set forth the broad parameters under which lenders should exercise their sound professional judgment as mortgage servicers in the performance of their duties. As a result, in most instances we have not set forth absolute requirements because we believe that servicers need to maintain the discretion to apply appropriate judgment in dealing with borrowers and loans on a case-by-case basis, consistent with our servicing policies.[260]

Fannie Mae generally will not object to the practices a servicer regularly applies so long as they are carried out in accordance with established written procedures that are consistent with Fannie

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[253] All Active Single-Family Loans chart from Marianne Sullivan, Senior Vice President, Credit Loss Management.

[254] *Id.*

[255] Mortgage Selling and Servicing Contract, I-A.

[256] *See* Mortgage Selling and Servicing Contract, I-C ("Whenever there is a reference to the Guides in this Contract, it means the Guides as they exist now and as they may be amended or supplemented in writing.").

[257] Interview with Daniel C. Smith, Deputy General Counsel, Legal Department (Oct. 14, 2005).

[258] Servicing Guide, I-202.

[259] *Id.*

[260] *Id.* The Selling Guide contains similar language. Selling Guide, I-201.01.

Mae's servicing policies.[261]

The Servicing Guide also "require[s] each Fannie Mae-approved servicer (and any subservicer or third-party originator it uses) *to be aware of, and in full compliance with, all federal, state, and local laws* (including statutes, regulations, ordinances, administrative rules and orders that have the effect of law, and judicial rulings and opinions) that apply to any of its origination, selling or servicing practices or other business practices (including the use of technology) that may have a material effect on [Fannie Mae].[262]

The Servicing Guide requires servicers to have trained staff and adequate procedures to conduct their duties and

> ... *to protect against fraud, misrepresentation, or negligence by any parties involved in the mortgage servicing processes*; to protect our investment in the security properties; and to provide borrowers with assistance when it is requested. Servicers should have effective processes to promptly address borrower inquiries (relating to both current and delinquent loans) and provide timely payoff quotes and refunds of escrow deposits after payoff.[263]

The guidelines encourage servicers to adopt servicing practices that allow for an appropriate level of discretion to take into account the facts of a particular loan and the circumstances of the borrower.[264]

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[261] Servicing Guide, I-202.

[262] Servicing Guide, I-306. It further states: "Among other things, this means that the servicer must comply with any applicable law that addresses fair housing, equal credit opportunity, truth-in-lending, wrongful discrimination, real estate settlement procedures, borrower privacy, escrow account administration, mortgage insurance cancellation, debt collection, credit reporting, electronic signatures or transactions, *predatory lending*, terrorist activity, or the enforcement of any of the terms of the mortgage.

Since applicable law can change quickly, sometimes without widespread notice, it is imperative that a servicer monitor federal requirements and the requirements of each state or locality in which it does business and take appropriate action to comply with any changes. If a change to applicable local or state law represents a potential conflict with our requirements, the servicer should advise its lead Fannie Mae regional office. *When we consider it appropriate, we may request a servicer to provide evidence of its compliance with any given jurisdictional requirement or applicable law.*"

[263] Servicing Guide, I-202.

[264] *Id.*

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Fannie Mae conducts performance monitoring on the status of the lender and also audits servicer records related to Fannie Mae mortgages.[265] Fannie Mae uses an array of analytical tools to track the performance of servicers. Fannie Mae monitors its servicers' performance by validating that the loan activity data reported to Fannie Mae is accurate; by checking if servicers are servicing Fannie Mae's loans in compliance with Fannie Mae's guidelines; by checking whether servicers are following the timelines Fannie Mae has established for foreclosure and bankruptcy actions; and by auditing servicers' records.[266]

Servicers provide Fannie Mae with information on a monthly basis about loan activity for the loans that they are servicing.[267] Servicers report "loan level" activity for all the loans that they service, whether they are held in Fannie Mae's portfolio or back MBS.[268] This information includes the last paid installment, the unpaid principal balance, principal, interest, actions taken on the loans, and fees collected.[269] Servicers also report "pool level" activity for loans that back MBS, which includes the outstanding security balance for fixed rate pools, and the security balance and aggregate pass through rate of the underlying adjustable loans for adjustable rate pools.[270]

Fannie Mae validates the loan activity information the servicers provide by comparing it with Fannie Mae's expectations on how the loans and pools of loans will

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[265] The Selling Guide I-104.

[266] Interview of Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005); interview with Robert Sanborn, Vice President of the National Servicing Organization (Dec. 16, 2005); interview with Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005); and Selling Guide, I-404.

[267] Interview of Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005)

[268] *Id.* This information is reported to a mortgage accounting system named LASER. Servicers report loan activity to Fannie Mae through the SURF or MORNET systems, or via a direct line to Fannie Mae.

[269] *Id.*

[270] *Id.* This information is reported to a computer system named MAST.

perform.[271] Fannie Mae's primary tasks are ensuring that servicers remit all the funds that Fannie Mae is due and ensuring that the appropriate funds are being passed on to investors.[272] In these reviews, Fannie Mae does not have a mechanism to ensure that the fees servicers are charging borrowers are appropriate.[273] Unusual activity – such as high default rates or other indications that loans are not performing as expected – would prompt Fannie Mae to conduct further reviews of a servicer.[274] The statistics are now being analyzed to assist in detecting lender or servicer fraud in the origination or servicing of loans.[275]

Fannie Mae employs servicing "consultants" who train servicers on how to comply with Fannie Mae's guidelines, as well as provide on-going consultation.[276] They also regularly review servicers' compliance with Fannie Mae's guidelines.[277] They monitor the servicers' performance by looking at factors such as the delinquency and loan level delays, which include servicers' delays in collecting on the loans and delays during foreclosure.[278] Consultants determine why the delays occurred and whether they are acceptable or not.[279] Servicers often ask on-site consultants for advice if they have difficulty interpreting Fannie Mae's guidelines or if they want to know if they are in compliance with Fannie Mae's standards.[280] Some servicing consultants are responsible for dozens of small servicers, while

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[271] *Id.*

[272] *Id.*

[273] *Id.*

[274] *Id.*

[275] *Id.*

[276] *Id.*

[277] *Id.*

[278] *Id.*

[279] *Id.*

[280] *Id.*

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others may be responsible for managing one large servicer.[281] The consultants are decentralized and report to portfolio managers.[282]

Consultants are responsible for ensuring that servicers are pursuing alternatives to foreclosures when borrowers are delinquent on their payments.[283] Mr. Lavalle has pointed to language contained on Fannie Mae's website as evidence that Fannie Mae is responsible for making the decision whether to foreclose and argues that Fannie Mae "order[s] the hit." The website states that Fannie Mae "employs 44 servicing consultants, who work as on-site consultants at [its] largest loan servicers, helping them manage problem loans on a case-by-case basis with judgment and speed."[284] Fannie Mae's policy is that if a loan goes into foreclosure, consultants work with the servicer, but consultants do not make the decision of whether to foreclose.[285]

Servicing specialists are part of the Centralized Servicing Operations Group, a division of the NSO.[286] Specialists are responsible for loss mitigation, loan administration, default management (which includes foreclosures and bankruptcy), and attorney supervision.[287] Loan administration includes reviewing loan level delays in foreclosures and bankruptcies to determine whether to assess a penalty against the servicer and reviewing reports of delinquent loans to determine if they were accurately reported as falling outside of Fannie Mae's guidelines

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[281] *Id.*

[282] *Id.*

[283] *Id.*

[284] Current Issues: Overview of Credit Risk Management at Fannie Mae, June 19, 2002, available at www.fanniemae.com.

[285] Interview with Robert Sanborn, Vice President of the National Servicing Organization (Dec. 16, 2005).

[286] Interview with Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005).

[287] *Id.*

("exception review").[288] Specialists audit the servicing records to ensure that penalties have been properly assessed and to conduct a review for loan level delays relating to title issues, servicing issues, litigation, bankruptcy and foreclosure.[289] In essence, servicing specialists focus on whether servicers are acting in a timely manner to protect Fannie Mae's interest. They are not responsible for determining whether servicers are engaging in predatory servicing. Servicing specialists also conduct a review of Fannie Mae-retained attorneys through the RAMN (Retained Attorney Management Network) system.

Servicers must permit Fannie Mae to examine certain records relating to mortgages they services for Fannie Mae.[290] The Selling Guide states that servicers must maintain their records in such a manner that would enable Fannie Mae to examine and audit them at any time. Mortgage files and records include the individual mortgage files, permanent mortgage account records, and accounting system reports. The accounting records relating to mortgages serviced for Fannie Mae must be maintained in accordance with sound and generally accepted accounting principles and in such a manner as will permit its representatives to examine and audit such records at any time.[291]

Fannie Mae reserves the right in its Mortgage Selling and Servicing Contracts to terminate a servicer with or without cause.[292] Grounds for terminating with cause include knowingly selling Fannie Mae a mortgage that has untrue mortgage warranties; failing to comply

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[288] Attachments to e-mail from Debbie Kehr, Director of Centralized Servicing Operations (Dec. 19, 2005).

[289] *Id.*; e-mail from Adam Womack, Servicing Process Manager, Quality Assurance (Dec. 19, 2005).

[290] Mortgage Selling and Servicing Contract, II-D.

[291] Selling Guide, I-404.

[292] Mortgage Selling and Servicing Contract, IX-C: "We may terminate servicing for any reason, by giving the Lender notice of the termination. If we do so, the provisions of this Contract covering the servicing of the affected mortgages will automatically terminate on the thirtieth day following the day our notice is given. ..." *See also* Servicing Guide, I-201.08. *See also* Selling Guide, I-201.07, which Fannie revised on January 31, 2006, and which contains similar language.

with the Fannie Mae Selling and Servicing Contract and Selling and Servicing Guides, by failing to keep accurate accounting and mortgage servicing records, or other non-performance; and failing to properly foreclose on a property when a borrower is in default. It also is a breach of the Mortgage Selling and Servicing Contract and grounds for termination if

> a court of competent jurisdiction finds that the Lender or any of its principal officers has committed an act of civil fraud; or the Lender or any of its principal officers is convicted of any criminal act related to the Lender's lending or mortgage selling or servicing activities or that, in [Fannie Mae's] opinion, adversely affects the Lender's reputation or [Fannie Mae's] reputation or interests.[293]

One of three business centers, the Eastern Business Center, Western Business Center, or National Business Center, is responsible for the relationship with each servicer, The business center responsible for a particular servicer works with the National Servicing Organization to determine whether to terminate that servicer.[294] The business center's Vice President of Operations, the Vice President in charge of the National Servicing Organization, and the Servicing Director must consent to the termination.[295]

Fannie Mae rarely has cause to terminate a servicer involuntarily. For the past three years the terminations have been:

2003	5
2004	2
2005	1[296]

Fannie Mae has a preference for trying to reform servicers with problems. In its view, an involuntary termination does not help anyone – it severely harms the servicer, who is no longer

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[293] Mortgage Selling and Servicing Contract, VIII-A.

[294] E-mail from Mercy Jimenez, Senior Vice President, National Business Center (Apr. 13, 2006).

[295] *Id.*

[296] E-mail attachment of a chart of all terminations, from Marianne Sullivan, Senior Vice President, Credit Loss Management (Mar. 3, 2006).

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Fannie Mae approved, and it harms borrowers whose loans are serviced by that servicer because it is no longer overseen by Fannie Mae.[297] Fannie Mae tries to reform a nonperforming servicer's behavior.[298] Fannie Mae believes that if it terminated the servicers, they might not ever change their poor practices.[299]

C. Best Practices – Fairbanks Consent Decree

Mr. Lavalle has requested Fannie Mae mandate a set of "best practices" that all of its servicers must follow.[300] These "best practices" would be based upon the practices Fairbanks Capital Corp. ("Fairbanks") and its parent Fairbanks Capital Holding Corp., agreed to implement in the 2003 consent order they entered into with FTC and HUD.[301] FTC and HUD accused Fairbanks of violating the Federal Trade Commission Act ("FTCA"), Fair Debt Collection Practices Act ("FDCPA"), Fair Credit Reporting Act ("FCRA") and Real Estate Settlement Procedures Act ("RESPA"). In settling the matter, Fairbanks and its parent agreed to refrain from engaging in certain predatory servicing practices and to provide borrowers with certain information pertaining to their loans.[302] The settlement, which was coordinated with a settlement in a class action lawsuit, also required the companies to pay the FTC $40 million to compensate

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[297] March 3, 2006, interview with Marianne Sullivan, Senior Vice President, Credit Loss Management (Mar. 3, 2006).

[298] *Id.*

[299] *Id.*

[300] E-mail from Nye Lavalle to Ms. House, Mr. Mudd, and Board of Director members Stephen Ashley, Ann Korologos, Frederic Malek, Donald Marron, Leslie Rahl, H. Patrick Swygert, and John Wulff, and others (July 22, 2005).

[301] *See U.S. v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. Oct. 6, 2003) (order preliminarily approving stipulated final judgment and order as to Fairbanks Capital Corp. and Fairbanks Capital Holding Corp.) (order preliminarily approving stipulated final judgment and order as to Fairbanks Capital Corp. and Fairbanks Capital Holding Corp.) [hereinafter "Consent Order"].

[302] Press Release, FTC, "Fairbanks Capital Settles FTC and HUD Charges" (Nov. 12, 2003).

victims of the fraud. The companies' founder and former CEO, Thomas D. Basmajian, also paid $400,000 in a separate settlement.[303]

Mr. Lavalle wants Fannie Mae to amend its Servicing Guide to include the servicing requirements contained in the Fairbanks consent order, as well as other requirements. He has drafted a Mortgage Servicing Best Practices Guide that he wants Fannie Mae to adopt.[304]

Fannie Mae did, in fact, review the Fairbanks consent order and amend portions of its Selling and Servicing Guides.[305] The amendments were made in a series of three announcements in 2004.[306] The consent decree was resolving a case in which the FTC found that Fairbanks had violated numerous legal requirements and therefore, its provisions were remedial. In addition, most of the issues addressed in the consent order pertained to practices primarily used by subprime servicers.[307] Most of Fannie Mae's servicers are prime servicers. Fannie Mae officials felt that many of the consent order requirements were not relevant to its universe of servicers.[308] Fannie Mae adjusted those practices that it viewed as relevant.[309] In some cases, the Fairbanks consent order required Fairbanks to do more than was required by the

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[303] *Id.*

[304] E-mail from Nye Lavalle to Mark Cymrot (Feb. 27, 2006). The Mortgage Servicing Best Practices were included in a report on predatory lending and servicing that he sent to Ms. House, Mr. Raines. *See* E-mail from Mr. Lavalle to undisclosed recipients (June 4, 2004).

[305] Interview with Marianne Sullivan, Single-Family Anti-Fraud Oversight (Senior Manager of Mortgage Servicing Policy); Telephone Interview with Ezzard Alves, Senior Manager of Mortgage Servicing Policy (Nov.17, 2005).

[306] *See* Announcement ("Ann.") 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines; Ann. 04-06: Authoritative Online Selling and Servicing Guides, Purchase of Massachusetts "High Cost Home Mortgage Loans," Mortgage Loan Documents, Arbitration, Waiver of Prepayment Premium, Guaranty Fees, and Escrow Accounts; and Ann. 04-07: Mortgages Secured by Manufactured Homes, Fannie Mae Purchase of Indiana "High Cost Home Mortgage Loans," Quality Assurance-Documentation Requirements, Southwestern Regional Location-Change of Physical Address, Lenders' Analysis of the Contract For Sale and Sale History of the Subject Property, Property Flipping, Comment Period for Revised Test Appraisal Forms, Servicing Transfers, Lender-Placed Property Insurance.

[307] Interview with Marianne Sullivan, Single-Family Anti-Fraud Oversight (Nov. 16, 2005).

[308] *Id.*

[309] *Id.*

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loan instruments.[310] Fannie Mae did not adopt those requirements because it thought it would face resistance from its servicers if it mandated that they do more than was actually required.[311]

The primary practices either prohibited by or mandated in the Fairbanks consent order relate to the following: (1) crediting payments, (2) misrepresentations, (3) escrow accounts, (4) force-placed insurance, (5) improper fees, (6) compliance with laws and regulations, (7) consumer complaints, (8) consumer information, (9) foreclosures, (10) late fees, and (11) forbearance agreements.[312] Fannie Mae's guidelines address many of these issues, but often not in as much detail or as explicitly.

1. Crediting Payments

In terms of crediting payments, Fairbanks was required to accept partial payments and credit all payments *as of the date of receipt*. Fannie Mae's Servicing Guide was amended in 2004 to add a section stating:

> It is the servicer's responsibility to ensure that its payment collection and posting processes enable the timely crediting of borrowers' accounts (including borrowers in bankruptcy) so that late charges are not inappropriately assessed or other actions, such as inaccurate reporting of delinquencies to credit bureaus, are not taken.[313]

Fannie Mae also encourages its servicers to periodically audit the automated processes they use to post payments to ensure they perform efficiently.[314] Mr. Lavalle asserts that Fannie Mae should require its servicers to post payments within 24 hours of receipt, and instantaneously

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[310] *Id.*

[311] *Id.*

[312] *See* Consent Order.

[313] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[314] *Id.*

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when payments are submitted electronically.[315] Fannie Mae's current requirements are not as stringent as Fairbanks' requirement, nor as stringent as Mr. Lavalle has requested.

As for partial payments, Fairbanks is enjoined from not accepting partial payments, but Fannie Mae's guidelines allow its servicers to reject partial payments in some cases. One provision of the Servicing Guide states that servicers should not automatically return partial payments to borrowers, but instead should base their decision on whether to accept the payment on the amount of the shortage and on any special circumstances that might justify the partial payment.[316] The Servicing Guide states that the servicer of a first mortgage should accept a partial payment and hold it as unapplied funds, instead of returning the payment, if the borrower "has a good attitude toward the mortgage obligation; is not habitually delinquent; does not have a history of remitting checks that are returned for 'insufficient funds'; and can pay the balance of the payment within the next 30 days."[317] Another provision states that "[a]s a rule, a servicer should accept partial payments only to help cure a delinquency" and that it should return partial payments when it believes that doing so will be an effective collection tool.[318] It also states, however, that servicers should not routinely return partial payments.[319]

The Servicing Guide provides that when servicers accept partial payments, they should apply the portion of the payments that equals one or more full installments and should hold the remaining portion as "unapplied funds" until it receives enough money to make a full

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[315] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[316] Servicing Guide, III-101.03: Payment Shortages.

[317] *Id.*

[318] *Id.*

[319] *Id.* It also states: "FHA, HUD, and VA require that partial payments be accepted under certain conditions that they specify."

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installment.[320] The total amount due for a conventional mortgage may include late charges or prepayment premiums, so Fannie Mae allows servicers to hold as unapplied, a payment that does not include a late or prepayment charge that is due.[321] The servicer then can use a portion of the next payment to make up the shortage so that the payment can be applied.[322] If a servicer does not consider late charges and prepayment premiums as part of the total amount due, it may return a short payment.[323] In either case, the servicer should inform borrowers of the actions taken and why, and the total amount that is due.[324]

Mr. Lavalle argues that servicers should never return payments to borrowers because payment reflects a borrower's willingness to fulfill its mortgage obligation.[325] He also argues that servicers should apply partial payments to principal and interest before applying them to any expenses or fees other than escrow expenses.[326] Fannie Mae does not agree with these opinions.[327] Fannie Mae's position is that some borrowers intentionally make partial payments or sporadic payments solely to prevent foreclosure, not to fulfill their mortgage obligations.[328]

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[320] Servicing Guide, III-101.03: Payment Shortages.

[321] *Id.*

[322] *Id.*

[323] *Id.*

[324] *Id.*

[325] *Id.*.

[326] Attachment from e-mail dated Feb. 27, 2006 from Nye Lavalle to Mark Cymrot.

[327] Servicing Guide, VII-202: Accepting Partial Payments (stating that servicers can return partial payments if they believe doing so will be an effective collection tool); and Servicing Guide, III-101.03: Payment Shortages (stating that servicers can hold payments that do not include late fees as unapplied and then apply a portion of the subsequent payment to make up the shortage).

[328] Telephone Interview with Zach Oppenheimer, Senior Vice President, Single-Family Mortgage Business, and Sam Smith, Vice President, Single Family Operations, Eastern Business Center (March 6, 2006).

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These provisions are therefore necessary to prevent borrowers from skirting their mortgage obligations, Fannie Mae argues.[329]

2. Misrepresentations and Fee Disclosures

As for servicer misrepresentations, Fairbanks is prohibited from misrepresenting the amount that a consumer owes, or misrepresenting that a fee is allowed if it is not, or the amount, nature or terms of the fee. It is also prohibited from "assessing and/or collecting any fee unless it is for services actually rendered and is (a) expressly authorized, and clearly and conspicuously disclosed, by the loan instruments and not prohibited by law; (b) expressly permitted by law and not prohibited by the loan instruments; or (c) a reasonable fee for a specific service requested by a consumer that is assessed and/or collected only after clear and conspicuous disclosure of the fee is provided to the consumer and explicit consent is obtained from the consumer to pay the fee in exchange for the service, and such fee is not otherwise prohibited by law or the loan instruments."[330]

In 2004, Fannie Mae amended its Servicing Guide to state that servicers should have clearly written policies regarding fee assessment that address four points in particular:

- The types or categories of fees, and the specific amounts of fees, if known, that the servicer can charge borrowers for services that are not regular servicing activities and are not covered in the servicing fee;
- Any fees servicers charge to borrowers or that Fannie Mae reimburses servicers for must be related to work that was actually performed by the servicer, either directly or indirectly by third parties;
- Servicers must clearly disclose the assessment of any fees to borrowers in advance of performing the service where practical, or subsequently. This does not apply to fees

[329] *Id.*

[330] *See* Consent Order.

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related to foreclosures and bankruptcy that are incurred to enforce the mortgage obligation, are allowed by the Servicing Guide, and that are disclosed if required by applicable law. If borrowers request services for which free or reduced-cost alternatives are available, the servicer must explain those options to borrowers before the services are provided; and

- Servicers can charge fees on a repetitive basis *only* when Fannie Mae's Guides require or permit it, or where it is otherwise clearly supported by the circumstances relating to a particular loan.[331]

Mr. Lavalle asserts that all fees must be disclosed to borrowers, individually identified (*i.e.*, the fee cannot be included or hidden within another fee), and cross-referenced to the provision of the promissory note or mortgage that allows it.[332] If borrowers challenge the legitimacy of the fees, servicers must provide a legal opinion and case law to support the fees, he argues.[333] In addition, he asserts that servicers should submit a schedule of fees it will charge borrowers to Fannie Mae for approval.[334] Finally, he wants Fannie Mae to prohibit commissions, kickbacks, and rebates on fees.[335]

Mr. Lavalle's demands regarding disclosure of fees are far beyond Fannie Mae's and Fairbanks' requirements. Both Fairbanks' and Fannie Mae's servicers are prohibited from charging fees for services that were not performed, and from charging fees that are not allowed by law or under the mortgage documents.[336] Fairbanks also is prohibited from imposing any fee or other action that is prohibited by any contractual agreement with the borrower. Fairbanks is

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[331] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[332] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[333] *Id.*

[334] *Id.*

[335] *Id.*

[336] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition, and Required Repairs Guidelines, and Special Servicing Guidelines.

not required, and Fannie Mae does not require its servicers, to inform borrowers which provision in the mortgage documents allow a particular fee, or provide case law to support fees if borrowers dispute them. Fannie Mae mandates that its servicers provide additional protection to borrowers by explaining to them whether less expensive alternatives for the services they requested are available. Fairbanks is not required to provide this information.

Under the consent order, Fairbanks is prohibited from assessing or collecting fees for demand letters or any other collection letters or notices, and, unless under certain conditions, for property inspections, broker's price opinions, and attorneys' fees. Fairbanks may not charge attorneys' fees to borrowers unless the fees are necessary to process a foreclosure sale or are otherwise expressly permitted by law or disclosed to borrowers who give consent, and a law firm has performed the services and charged Fairbanks for them.[337]

Fannie Mae clarified in a 2004 announcement that servicers should not charge fees related to the following activities to borrowers:

- Handling borrower disputes and facilitating routine borrower collections;
- Arranging repayment or forbearance plans;
- Sending demand or breach letters relating to the non-payment of principal, interest, taxes, or insurance before sending a formal acceleration notice that matures the principal balance and begins the foreclosure process; and
- Updating records to "reinstate" a loan that has been brought current.[338]

Fannie Mae servicers can charge for servicing activities that borrowers request and that are not covered in the servicing fee Fannie Mae pays them. These activities include "work related to a

[337] Consent Order, p. 12.

[338] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

change in ownership of the security property, replacement of insurance policies, a release of the security, providing expedited service via fax, providing more than one payoff statement in a short period of time (or even a single payoff statement if applicable law expressly permits a borrower fee), providing duplicate copies of loan documents, accepting a 'phone pay' payment, and consummating the assumption or modification of a loan."[339] Fannie Mae's servicers also can charge borrowers for legal service fees in cases in which their mortgage states that the borrower will reimburse the servicer for any legal service fees and costs it incurs.[340] The Guide states that the "servicer's legal counsel should attempt to handle such matters by stipulation or any other expeditious manner that will reduce the fees and costs that the borrower has to pay."[341]

Mr. Lavalle argues that borrowers should not be charged fees for any services that Fannie Mae or the investor requested, including inspection fees and broker's price opinions.[342] Servicers also must provide invoices and cancelled checks for broker's price opinions, and inspections upon request from borrowers, he contends.[343] Additionally, he asserts that payoff statements should be routine and borrowers should be able to retrieve them on-line.[344] As for attorneys' fees, he asserts that when borrowers pay off or refinance their loans, they should not be charged for the attorneys' fees the servicers incurred when the borrower sued the servicer

[339] Servicing Guide, I-203.04: Fees for Special Services.

[340] Servicing Guide, III-501: Uncontested Routine Legal Actions.

[341] *Id.*

[342] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[343] *Id.*

[344] *Id.*

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over a dispute or to prevent foreclosure.[345] He also states that servicers must provide invoices and cancelled checks for legal fees upon request from borrowers.[346]

Mr. Lavalle's demands exceed Fannie Mae's and Fairbanks' practices. Fairbanks does not charge for property inspections and broker's price opinions, but Fannie Mae does not prohibit its servicers from charging for these services. In addition, Fannie Mae does not require its servicers to provide invoices and cancelled checks for these services and for attorneys' fees. Fairbanks also is not required to provide borrowers with invoices and cancelled checks for attorneys' fees. Both Fannie Mae and Fairbanks do not charge borrowers for demand letters.

3. Escrow Disbursements

The Fairbanks consent order prohibits Fairbanks from failing to make disbursements of escrow funds for insurance, taxes and other charges in a timely manner.[347] Fannie Mae amended its policies on escrow deposit accounts and escrow administration following the Fairbanks consent order, but the amendments dealt with the waiver of the escrow deposit account requirement and when a servicer is required to begin escrowing taxes and insurance.[348] Fannie Mae's Servicing Guide states that servicers of first mortgages must assume responsibility for administering escrow deposit accounts in accordance with the mortgage documents and all applicable laws and government regulations.[349] RESPA states that if the terms of a loan require the borrower to deposit money into an escrow account that the servicer

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[345] *Id.*

[346] *Id.*

[347] Consent Order, p. 8.

[348] Ann. 04-06: Authoritative Online Selling and Servicing Guides, Purchase of Massachusetts "High Cost Home Mortgage Loans," Mortgage Loan Documents, Arbitration, Waiver of Prepayment Premium, Guaranty Fees, and Escrow Accounts.

[349] Servicing Guide, III-103: Escrow Deposit Accounts. *See also* Servicing Guide, I-306: Compliance with Applicable Laws, which states, in part, that servicers must comply with any applicable law that addresses escrow account administration.

manages so that the servicer can assure tax, insurance premium and other payments, the servicer must make payments from the escrow account for those purposes "in a timely manner as such payments become due."[350]

Mr. Lavalle asserts that when borrowers write "qualified written request" letters, servicers should provide them with documentation, such as receipts, invoices and cancelled checks for payment of escrow charges.[351] A qualified written request is defined under RESPA as a written correspondence on something other than a payment medium (*i.e.*, not written on the check) that identifies the borrower and his or her account and includes a statement as to why the borrower believes the account is in error or states other information that the borrower seeks.[352] In addition, Mr. Lavalle asserts that Fannie Mae should prohibit servicers from dumping late fees, broker's price opinion fees, appraisal fees, and attorneys' fees into escrow accounts.[353] He also contends that servicers dump fees discharged in bankruptcy into escrow accounts and other adjustments.[354] Finally, Mr. Lavalle argues that servicers should provide programs on their website for borrowers to analyze their escrow accounts.[355]

Both Fairbanks and other Fannie Mae servicers must disburse escrow funds in a timely manner.[356] Fannie Mae does not require its servicers to provide receipts, invoices and cancelled checks when borrowers send qualified written request letters about escrow account

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[350] 12 U.S.C. § 2605(g).

[351] Ann. 04-06: Authoritative Online Selling and Servicing Guides, Purchase of Massachusetts "High Cost Home Mortgage Loans," Mortgage Loan Documents, Arbitration, Waiver of Prepayment Premium, Guaranty Fees, and Escrow Accounts.

[352] 12 U.S.C. § 2605(e)(1)(B).

[353] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[354] *Id.*

[355] *Id.*

[356] Servicing Guide, III-103: Escrow Deposit Accounts (requiring servicers to administer escrow accounts in compliance with all applicable laws); 12 U.S.C. § 2605(g) (requiring servicers to make payments from escrow accounts in a timely manner).

payments, and Fairbanks does not have to provide these items either. RESPA requires servicers to respond to qualified written requests by acknowledging receipt of the letter within 20 days of receipt, and by correcting the borrower's account or determining the account is correct within 60 days of receipt.[357] It does not require servicers to send the documentation Mr. Lavalle asserts they should send. The consent order and Fannie Mae's guides do not address Mr. Lavalle's allegations and complaints about broker's price opinion, appraisal and attorneys' fees and fees discharged in bankruptcy being dumped into escrow accounts.

4. Force-Placed Insurance

Fairbanks was prohibited from charging for force-placed insurance before providing the consumer with adequate notice and time to demonstrate that he or she already has insurance coverage, and various related practices.[358] The Fairbanks consent order specifies how many notices Fairbanks must send, and when they must send them, before charging borrowers for force-placed insurance.[359] Fannie Mae amended its Servicing Guide in 2004 to require servicers to attempt to reach borrowers for evidence that they have insurance before issuing force-placed insurance coverage, which it refers to as lender-placed insurance.[360] The Servicing Guide states how servicers should attempt to contact borrowers, what information they must provide borrowers, and how long they must wait before charging borrowers for force-placed

[357] 12 U.S.C. § 2605(e).

[358] *See* Consent Order.

[359] *Id.*

[360] Servicing Guide Part II, Chapter 6: Lender-Placed Property Insurance. Fannie Mae amended the Servicing Guide in an Announcement on November 8, 2004 (Ann. 04-07), but servicers were not required to implement the new requirements until February 1, 2005.

insurance.[361] Servicers also are to have adequate resources to process documentation that borrowers submit that shows they have coverage.[362]

Mr. Lavalle asserts that servicers should pay borrowers' insurance instead of placing force-placed insurance, unless insurance companies will not accept it.[363] However, if servicers do place force-placed insurance, he asserts they should abide by a detailed timeline and procedures that provide more protection to borrowers. For instance, Fairbanks only must wait a total of 50 days after the mailing before charging for force-placed insurance, while Fannie Mae instructs its servicers to typically allow 60 days for the borrower to provide evidence of coverage before charging for force-placed insurance. Fairbanks, however, is required to send two letters to the borrower, while Fannie Mae only requires its servicers to send one letter to borrowers. Mr. Lavalle proposes that Fannie Mae servicers not be allowed to charge for force-placed insurance from 105 to 135 days after the first mailing. He also proposes servicers attempt to make contact with the borrower or its agent seven times before charging for force-placed insurance, while Fairbanks must make only two attempts. Fannie Mae requires it servicers to make "attempts" to contact the borrower before force-placing insurance, but does not stipulate how many are required.[364]

As for confirmation of borrower-placed insurance, Fairbanks is prohibited from failing to accept reasonable confirmation from borrowers of insurance coverage or from placing force-placed insurance on borrowers' homes even if the servicer knows or did not take

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[361] *Id.*

[362] *Id.*

[363] Ann. 04-06: Authoritative Online Selling and Servicing Guides, Purchase of Massachusetts "High Cost Home Mortgage Loans," Mortgage Loan Documents, Arbitration, Waiver of Prepayment Premium, Guaranty Fees, and Escrow Accounts.

[364] Servicing Guide Part II, Chapter 6: Lender-Placed Property Insurance.

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reasonable actions to determine whether the borrowers have their own insurance. Fairbanks is also prohibited from placing a loan in default, assessing late fees, or initiating foreclosure proceedings solely due to the borrower's non-payment of insurance premiums. It is required, within 15 days of receiving confirmation of the borrower's existing insurance coverage, to refund all force-placed insurance premiums and any related fees paid during the period in which there was overlapping coverage.

Fannie Mae's Servicing Guide states that if the borrower provides evidence of coverage, within a reasonable time the servicer must refund or credit to the borrower the total amount of any premiums it charged for force-placed insurance after the effective date of the borrower-placed coverage, as well as any late charges it assessed due to nonpayment of the force-placed insurance premiums.[365] Fannie Mae stated in a 2004 announcement that the "failure of a borrower to pay any *miscellaneous* fees assessed when the borrower is otherwise current with respect with the total amount due on his or her basic mortgage obligation (principal, interest, taxes, insurance, late charges, and any prepayment charges) *generally should not result in the acceleration of the loan and commencement of foreclosure proceedings.*"[366] Fannie Mae prohibits servicers from initiating *foreclosure proceedings due solely to late charges.*[367] Nonetheless, a specific prohibition from initiating foreclosure proceedings due to non-payment of insurance is not contained in Fannie Mae's Guides.

Mr. Lavalle argues that if insurance is ordered and the borrower then provides evidence that it was wrongly placed, any money deducted from the payments must be applied to

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[365] *Id.*

[366] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[367] Servicing Guide, VII- 201: Assessing Late Charges, stating "the servicer cannot foreclose the mortgage later if the only delinquent amount is unpaid late charges."

the loan and the loan must be reamortized from the point of misapplication.[368] He also claims that if borrowers secure insurance, servicers must cancel force-placed insurance on the date they receive notice of borrower-placed insurance, and must credit borrowers' accounts for any unused portion of the force-placed insurance on the date of notice.[369] Also, servicers should disclose the carrier, master policy number and commissions, rebates or any free services the carrier provides to the servicer, Mr. Lavalle argues.[370] Finally, he asserts that when servicing is transferred, the new servicer should not be able to cancel the prior force-placed insurance to create its own force-placed insurance policy.[371]

Mr. Lavalle believes that borrowers should be credited for unnecessary force-placed insurance quicker than Fairbanks and Fannie Mae's servicers are required to credit borrowers. Fairbanks must refund force-placed insurance premiums within 15 days of receiving confirmation of borrower-placed insurance, and Fannie Mae's servicers must refund the insurance "within a reasonable time."[372] Mr. Lavalle asserts that if borrowers secure insurance, servicers must credit borrowers on the date of notice for any unused portion of the force-placed insurance.[373] Fannie Mae's Servicing Guide and the Fairbanks consent order do not address Mr. Lavalle's proposal that servicers disclose certain information about the insurance carrier, nor do they address the cancellation and placement of new force-placed insurance when servicing is transferred. Unlike the Fairbanks consent order, Fannie Mae's Servicing Guide does not contain a specific provision that states that servicers must accept reasonable confirmation of borrower-

[368] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[369] Mortgage Servicing Best Practices, in the section entitled "Taxes & Insurance."

[370] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[371] *Id.*

[372] Servicing Guide, II, Chapter 6: Lender-Placed Property Insurance.

[373] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

placed insurance and must not place force-placed insurance on borrowers' homes even if servicers know the borrower has insurance. The Servicing Guide also does not specifically prohibit servicers from placing loans into default, charging late fees, or initiating foreclosures due solely to borrowers not paying insurance premiums. The consent order resulted from a class action lawsuit, and thus prohibits specific acts that Fairbanks was alleged to have committed. By and large, Fannie Mae's servicers have not engaged in these actions, and thus Fannie Mae's Servicing Guide does not specifically state that these actions are prohibited.

5. Consumer Services

Regarding consumer services, Fairbanks is required to maintain a toll-free number and address dedicated to handling consumer disputes and questions, and the toll-free number must be staffed for certain hours that are set in the consent order. The consent order also establishes deadlines by which Fairbanks must respond to and investigate consumer disputes. In addition, under the consent order, Fairbanks must not take "any legal or other action to collect the disputed amount and any related charges until the dispute has been investigated and the consumer has been informed of the results of the investigation."[374]

Fannie Mae requirements for its servicers, amended in 2004, are not as detailed as the ones contained in the consent order. Fannie Mae requires its servicers to respond promptly to all borrower inquiries about the terms of their mortgages, the status of their accounts, and any actions servicers took, or did not take, in servicing their mortgages.[375] Fannie Mae particularly expects its servicers to respond promptly to borrowers when they have a dispute with the servicer, as well as expects its servicers to have effective means to communicate with its

[374] Consent Order, p. 17.

[375] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

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borrowers in such as way to help resolve the dispute.[376] Fannie Mae expects its servicers to resolve disputes without assessing additional fees on borrowers.[377] In 2004, Fannie Mae amended its policies to state that if a servicer is having an "ongoing bona fide dispute with a borrower," Fannie Mae expects that it "generally will not commence foreclosure proceedings without a thorough review of the circumstances surrounding that dispute and reasonable efforts to resolve the dispute."[378]

When borrowers send qualified written requests for information regarding servicing to Fannie Mae servicers, RESPA requires the servicers to provide a written response acknowledging receipt of a letter within 20 days of receipt.[379] Within 60 days of receipt of the request, servicers must correct the borrower's account and send the borrower a written notification of the correction.[380] After investigating the matter, servicers must provide the borrower with a written explanation that includes a statement of why the servicer believes its determination of the account is correct and who can provide assistance to the borrower, or provide the borrower with an explanation of why the information the borrower requested is unavailable and who can provide assistance to the borrower.[381]

Mr. Lavalle asserts that servicers do not promptly respond to borrower inquiries. He states that a national mortgage ombudsman position should be created to provide servicer oversight.[382] The ombudsman would audit and review servicers and arbitrate disputes.[383] It

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[376] *Id.*

[377] *Id.*

[378] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[379] 12 U.S.C. § 2605(e)(1)(A).

[380] 12 U.S.C. § 2605(e)(2).

[381] *Id.*

[382] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

would be supported by a center of mortgage experts and advocates and paid for by mortgage companies.[384] He also advocates a Borrower Bill of Rights, which would entitle borrowers to review all information servicers have about the borrowers and their mortgages, including transfers and the assignment of the promissory note, mortgage and servicing rights.[385] Borrowers also would have knowledge of all current servicers, including the master, sub-servicers and special servicers, and the trustee and trusts to which their loan belonged.[386] Borrowers would receive the general ledgers for current and past servicers, and a layman's guide to the terms and conditions of their loans.[387] Finally, borrowers would be able to determine their document custodians, have a right to inspect their notes, and receive their note on payoff or refinance.[388] In addition, Mr. Lavalle states that Fannie Mae's Servicing Guide should catalog all the activities that servicers cannot do when resolving consumer disputes.[389]

Fannie Mae requires its servicers to promptly respond to borrower inquiries, but Fannie Mae's requirements do not contain details as to how and when servicers should respond. RESPA, which Fannie Mae servicers must follow, provides a more concrete timeline for responding to borrower inquires.[390] Neither the Fairbanks consent order nor Fannie Mae Servicing Guide requires servicers to inform borrowers of all the identities of those servicing their loan and the trustee and trust to which their loan belongs and the identity of the document custodian; to provide borrowers with all information about transfers and assignment of their

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[383] *Id.*

[384] *Id.*.

[385] *Id.*

[386] *Id.*

[387] *Id.*

[388] *Id.*

[389] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[390] *See* 12 U.S.C. § 2605(e).

notes and the general ledgers of all servicers; or to provide borrowers with their notes on pay off if not required by the state.

6. Consumer Credit Ratings

As for consumer ratings, under the consent order, Fairbanks cannot threaten a borrower's credit rating or report the consumer as delinquent based on a disputed amount until the dispute has been investigated, and the borrower has been informed of the results of the investigation. Fannie Mae amended its Servicing Guide to state that when borrowers become seriously delinquent, servicers must inform them that the servicers have reported their mortgage delinquency to the major credit repositories, and that this may affect their ability to obtain credit.[391] RESPA prohibits Fannie Mae's servicers from providing information regarding an overdue payment to a consumer reporting agency within the 60 days of receiving a qualified written request from a borrower related to the dispute over payments.[392] The Servicing Guide states that servicers must accurately and completely report borrowers' mortgage status, resolve any disputes that result from the reported information, and promptly respond to borrowers' questions regarding the reported information.[393] Servicers also must comply with all applicable provisions of the Fair Credit Reporting Act.[394] In order to further consumer service, in 2004 Fannie Mae made an announcement suggesting that servicers consider the merits of implementing delinquency management, dispute resolution, and customer service improvements.

[391] Servicing Guide, VII-107: Notifying Credit Repositories.

[392] 12 U.S.C. § 2605(e)(3).

[393] Servicing Guide, VII-107: Notifying Credit Repositories.

[394] *Id.*

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Mr. Lavalle asserts that borrowers should have access to credit scores, delinquency scores, and servicing scores for a minimum cost.[395] He also asserts that an industry database on borrower inquiries and complaints should be established, and Fannie Mae should audit it to determine if servicers are in compliance with its Guides and take action if they are not.[396] He also argues that lenders and servicers should fund a central web and phone complaint site where complaints are monitored and acted upon.[397] An independent monitor and ombudsman committee would review the complaints, and borrowers would be offered arbitration and mediation for any dispute than could not be resolved.[398] If these processes did not resolve the dispute, each side would submit their offer and proof of facts and a panel would make the award.[399]

Mr. Lavalle asserts that Fannie Mae's suggestion that servicers create a staff to research and resolve borrower payment disputes while the borrower is on the telephone is not feasible.[400] First, servicers do not have prior servicing records, which must be audited, Mr. Lavalle asserts. Second, many servicers outsource servicing representatives to other countries, which leads to miscommunication; thus, disputes cannot be resolved over the phone, he alleges. To resolve these problems, Fannie Mae should notify borrowers when it discovers fraud on their accounts and instruct MARI and MERS to open their databases to borrowers for a fee so borrowers can investigate servicing problems themselves.[401]

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[395] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[396] *Id.*

[397] *Id.*

[398] *Id.*

[399] *Id.*

[400] *Id.*

[401] *Id.*

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As for Fannie Mae's suggestion that servicers call borrowers who have loans greater than 90 days delinquent, Mr. Lavalle states that servicers must not contact borrowers who are represented by counsel in foreclosures. He argues that to ensure servicers do not contact represented borrowers, servicers should create certain processes, such as a field in their systems that indicate whether the borrower is represented.[402] As for programs for delinquent borrowers, Mr. Lavalle suggests web seminars and CDs that are available for download on-line and that inform borrowers of their rights and responsibilities and how to avoid foreclosure, and that provide information about credit scoring.[403]

Unlike the Fairbanks consent order, Fannie Mae's Servicing Guide does not prevent borrowers from threatening a borrower's credit rating or report the borrower as delinquent based on a dispute until the dispute has been resolved and the borrower informed of the results. Again, the consent order specifies acts that Fairbanks was alleged to have committed, whereas the Servicing Guide contains general provisions for servicers to follow. The Guide states that its servicers must accurately report borrower mortgage status, and that servicers are responsible for resolving any dispute that results from reporting information about the borrower to credit repositories.[404] Furthermore, if borrowers send qualified written requests to servicers about a dispute over payment, RESPA prohibits servicers from reporting the overdue payment to credit repositories within 60 days of receiving the letter.[405] Servicers are required to follow all applicable laws, which include RESPA.

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[402] *Id.*

[403] *Id.*

[404] Servicing Guide, VII-107.

[405] 12 U.S.C. § 2605(e)(3).

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Fannie Mae also has made several recommendations regarding customer service to its servicers. Mr. Lavalle has made several proposals that he wants the mortgage industry as a whole to implement, such as creating an industry-wide web and telephone complaint site and database, and creating an independent monitor and ombudsman committee to review complaints.

7. Consumer Information

Fairbanks must timely inform consumers prior to the due date of each monthly payment of the following, with limited exceptions: information regarding unpaid principal balance; the due date and amount due; reasons for changes in the amount due; an itemization of each fee assessed during the statement period; the telephone number and address for consumers to use if they dispute any of the information provided; and the total amount due.

Fannie Mae's Guides do not contain any provision that requires this information to be provided monthly. Under Fannie Mae's Servicing Guide, by January 31 of each year, the servicer must send "the borrower a statement of activity in his or her mortgage account during the past year."[406] The information in the statement varies depending on whether the mortgage is a regularly amortizing mortgage or a reverse mortgage.[407] In addition to this annual statement, "[t]he servicer also must provide a detailed analysis of all transactions relating to a borrower's payments or escrow deposit account whenever the borrower requests it. The servicer cannot charge the borrower for the annual statement or the detailed analysis."[408]

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[406] Servicing Guide, III-104: Mortgage Account Statements.

[407] *Id.*

[408] *Id.*

Aside from adopting the Fairbanks requirements regarding consumer information, Mr. Lavalle asserts that Fannie Mae should require its servicers to individually identify each fee charged and cross-reference them to the provisions of the loan documents that allow the fees.[409]

Fairbanks is required to provide certain information to borrowers on a monthly basis. Fannie Mae does not require its servicers to provide this information each month, but it does require its servicers to provide borrowers with more comprehensive information – a detailed analysis of all transactions – whenever borrowers request it.[410] Fannie Mae also is required to send an annual account of mortgage activity to borrowers.[411]

8. Foreclosures

As for foreclosures, Fairbanks is prohibited from taking any action towards foreclosure until it has (1) reviewed the consumer's records to verify that the consumer missed three monthly payments; (2) confirmed that the consumer has not been subjected to any of the acts or practices prohibited in the consent order, the loan instruments, or by law, or if the consumer has been subjected to those practices, that Fairbanks has remedied them; and (3) investigated any of the consumer's disputes and informed the consumer of the results of the investigation.

Fannie Mae's Servicing Guide states that before referring a loan to a foreclosure attorney or trustee, servicers "should make every reasonable effort to conduct a personal face-to-face interview with the borrower and to cure the delinquency through [Fannie Mae's] special relief provisions or loss mitigation alternatives before referring a loan to the foreclosure attorney

[409] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[410] Servicing Guide, III-104: Mortgage Account Statements.

[411] *Id.*

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or trustee."[412] Servicers also must inspect the property and analyze the individual circumstances of the delinquency before referring the loan for foreclosure.[413] Aside from those provisions, the Servicing Guide states that foreclosure proceedings generally can begin whenever at least three full monthly installments are past due.[414]

Fannie Mae's policy is that failure to pay any miscellaneous fee generally should not result in acceleration of the loan if the borrower is otherwise current on the loan.[415] However, it does allow for acceleration due to the non-payment of miscellaneous fees in some cases. Fannie Mae stated in a 2004 announcement amending the Servicing Guide that "chronic or intentional disregard by the borrower of the obligation to pay legitimate fees secured by the mortgage obligation when the borrower appears to have the means to pay those fees, the fees have been clearly disclosed to the borrower, and the servicer has attempted to resolve any dispute regarding the fees, could be an acceptable instance in which to accelerate the loan obligation."[416]

Mr. Lavalle asserts that this policy led to his family's foreclosure.[417] He asserts that as long as principal, interest and escrow payment are made, servicers should not be permitted to foreclose.[418] He states that allowing servicers to accelerate the loan because it has not made other payments encourages foreclosures and predatory servicing because it enables

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[412] Servicing Guide, VIII, Chapter 1: Foreclosures.

[413] *Id.*

[414] Servicing Guide, VIII-102.

[415] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines (07/30/04).

[416] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines (07/30/04).

[417] Attachment to e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[418] *Id.*

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servicers to commit improper acts and trigger defaults.[419] He argues that the policy amounts to extortion – the servicer tells the borrower "PAY US WHAT WE CLAIM OR ELSE!"[420]

Both the Fairbanks consent order and Fannie Mae's Servicing Guide state that a borrower must miss three monthly payments before a servicer can initiate foreclosure proceedings.[421] They also both contain provisions for protecting borrowers by requiring either the servicer to investigate borrowers' disputes or make every reasonable effort to cure the delinquency before foreclosure. Ordinarily, servicers cannot accelerate a loan due to the borrower not paying miscellaneous fees; however, servicers can in certain instances. Mr. Lavalle believes that accelerating a loan for this reason is never acceptable.

9. Late Charges

As for late charges, Fairbanks is enjoined from pyramiding late charges (applying a portion of a payment to a previous late fee, leaving part of the scheduled payment overdue) and from charging a late fee or delinquency charge once a loan account has been accelerated to foreclosure status.

Fannie Mae's policy states that if a payment is sufficient to cover the mortgage obligation except for late charges, servicers generally should apply the payment and defer collection of the late charge.[422] However, in certain cases, such as when borrowers chronically disregard late charges even when they appear to be able to pay them, Fannie Mae permits servicers to hold the payments as unapplied or return them to borrowers.[423] When the borrower

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[419] *Id.*

[420] *Id.*

[421] Consent Order, p. 19; Servicing Guide, VIII-102.

[422] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[423] *Id.*

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makes his or her next payment, the servicer can use a portion of the payment to make up the previous month's shortage and apply the payment.[424] Fannie Mae views these actions as effective collection tools to bring borrowers current.[425] Fannie Mae requires it servicers to notify borrowers of the actions taken and why, and the amount that must be paid.[426] It also generally requires its servicers to apply incomplete payments in accordance with the hierarchy established in borrowers' mortgage documents.[427]

Mr. Lavalle argues that Fannie Mae should prohibit servicers from pyramiding late fees, from charging late fees while a charge is being disputed, and from charging late fees from prior servicers unless they produce the records from all prior servicers.[428] He argues that late fees should be charged only for late payments of principal and interest, and that late fees should not be charged for assessed fees and charges.[429] He also asserts that servicers must apply payments to principal and interest before applying them to late fees.[430]

Mr. Lavalle states that Fannie Mae's policy of not applying payments or returning payments that do not include late fees also led to his family's problems. He argues that servicers must credit all principal and interest payments that bring the loan to within 60 days delinquent without regard to special or legal fees.[431] He also asserts that servicers should never return payments to borrowers because payments reflect borrowers' willingness to pay their

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[424] Servicing Guide, III-101.03: Payment Shortages.

[425] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[426] *Id.*

[427] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines.

[428] Attachment to e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

[429] *Id.*

[430] *Id.*

[431] *Id.*

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mortgages.[432] He further argues that no money should ever be in an unapplied or suspended account for more than two days, and that when servicers send demands that do not credit unapplied and suspended accounts, borrowers send more money than they actually owe.[433] He argues that servicers should not be permitted to demand that funds be certified and that checks clear within two days, unless it is within one week of the foreclosure sale date.[434] Finally, he asserts that late fees should be a liquidated damages measure for all expenses incurred for late payment, and if not, the late fee portion of the payment should be eliminated, and a flat fee pricing that includes actual damages should be included.[435]

Fairbanks is prohibited from pyramiding late fees, but Fannie Mae allows its servicers to pyramid these fees by holding payments that do not include the fees as unapplied and then using a portion of the subsequent payment to cover the late fees. [436] Mr. Lavalle asserts that servicers should not be allowed to pyramid late fees or hold payments as unapplied for more than two days.[437] Fairbanks is required to apply payments on the date of receipt.

Lastly, unlike the Fairbanks consent order, Fannie Mae's Guides do not prohibit servicers from charging a late fee or a delinquency charge once a loan has been accelerated to foreclosure status, nor do they prohibit its servicers from enforcing any clause in forbearance agreements that require the consumer to acknowledge his or her lack of claims or defenses, waive access to court or otherwise waive or release any rights or claims.

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[432] *Id.*

[433] *Id.*

[434] *Id.*

[435] *Id.*

[436] Ann. 04-04: Test Period for Revised Appraisal Report Forms, Property Condition and Required Repairs Guidelines, and Special Servicing Guidelines; Servicing Guide, III-101.03: Payment Shortages.

[437] Attachment from e-mail dated Feb. 27, 2006, from Nye Lavalle to Mark Cymrot.

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Mr. Lavalle's "best practices" proposal exceeds both what Fairbanks is required to do under the consent order, and what Fannie Mae requires its servicers to do. Implementing all of Mr. Lavalle's proposals would significantly increase servicing costs, which would ultimately result in increased costs to borrowers. Mr. Lavalle has requested Fannie Mae to implement practices far beyond what is required by law, and even what is required by the Fairbanks consent order.

D. Mr. Lavalle's Problem Servicers

Mr. Lavalle has identified EMC Mortgage, Litton Loan Servicing, Ocwen and SPS (formerly Fairbanks), as servicers that rampantly engage in predatory servicing. As indicated previously, these entities service a very small portion of the loans that Fannie Mae owns. In addition, Fannie Mae loans make up a small percentage of the loans that each of these servicers service.[438] These servicers are the four major subprime servicers.[439]

The following chart shows the percentage of Fannie Mae loans for which these entities were primary servicers from 2002 through 2005. These figures were reported in December of the respective years.[440]

Year	Servicer	Number of Loans Serviced	Percentage of Total Loans Serviced	Unpaid Principal Balance	Percentage of UPB
2002	EMC	8,640	0.06%	1,078,489,005	0.07%
	OCWEN	2,739	0.02%	234,950,604	0.02%
	LITTON	862	0.006%	41,031,228	0.003%
	SPS	13,056	0.09%	1,571,825,743	0.1%
	Total	**14,209,500**	**100%**	**1,554,637,980,359**	**100%**

[438] Telephone Interview, Rick Bauerband, Director of Non-Traditional Servicing (March 14, 2006). *See also* attachments from March 9, 2006 e-mail from Richard Bauerband, on behalf of Robert Sanborn, Vice President, National Servicing Organization.

[439] Telephone Interview, Rick Bauerband, Director of Non-Traditional Servicing (March 14, 2006).

[440] Telephone interview with Marianne Sullivan, Senior Vice President, Credit Loss Management (March 17, 2006). Fannie Mae only maintains statistics on the number of loans serviced for "servicers of record," which are primary servicers.

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2003	EMC	11,433	0.07%	1,667,110,148	0.09%
	OCWEN	1,624	0.01%	108,800,663	0.006%
	LITTON	639	0.004%	29,366,579	0.002%
	SPS	8,668	0.05%	954,341,936	0.05%
	Total	**15,756,764**	**100%**	**1,922,037,101,322**	**100%**
2004	EMC	11,765	0.08%	1,803,491,876	0.09%
	OCWEN	992	0.006%	44,173,505	0.002%
	LITTON	454	0.003%	19,445,077	0.001%
	SPS	5,518	0.04%	542,535,828	0.03%
	Total	**15,647,451**	**100%**	**1,955,525,953,426**	**100%**

The small percentage of mortgages these servicers service for Fannie Mae demonstrates that Mr. Lavalle's concerns about the negative effect these servicers may have on Fannie Mae are overstated.

These servicers generally perform on par with other Fannie Mae servicers. For instance, Fannie Mae requested these servicers to repurchase only a small number of loans from 2002 to 2004. During that period, it requested servicers to repurchase more than 10,000 loans.[441] EMC repurchased only five active loans and 12 post-default loans. (Post-default repurchases occur when the National Underwriting Center conducts a post-foreclosure review of a loan and finds a "significant finding" that warrants the lender repurchasing the loan).[442] Fairbanks repurchased two active loans and no post-default loans during that period.[443] Ocwen repurchased one active loan and three post-default loans.[444] Litton did not repurchase any loans.[445] Due to

[441] E-mail dated Mar. 1, 2006, from Marianne Sullivan, Senior Vice President, Credit Loss Management, to Mark Cymrot, with attachment of a chart of the Repurchases for 2002-2004.

[442] *Id.*

[443] *Id.*

[444] *Id.*

[445] *Id.*

data limitations, in some cases Fannie Mae could not determine whether the repurchases were required due to problems in origination or in servicing.[446]

EMC, a subsidiary of Bear Stearns Cos., is a particular target of Mr. Lavalle's anger, as the servicer that foreclosed on his parents' house. He claims that he is going to put forth a corporate resolution to Fannie Mae with a proxy from his trustee to vote their shares to cease all business with EMC, if Fannie Mae does not cease business with EMC itself.[447] EMC currently services about 15,500 Fannie Mae accounts worth a total of $2.6 billion, and subservices about 7,500 accounts worth about $1.25 billion.[448] A servicing consultant visits EMC at least quarterly and has discovered no major problems in recent visits.[449] Three ratings agencies gave high marks to EMC in 2005. Moody's gave EMC its highest rating for subprime loans (SQ1); Standard & Poor's ("S&P") rated EMC as above-average; and Fitch Ratings gave it its highest ranking as a subprime servicer (RPS1).[450] Fannie Mae's Counter-Party Risk Management group reviewed EMC in the summer of 2005 and found no problems.[451]

In December 2005, the FTC issued a civil investigative demand to EMC to provide data and documents regarding its business and servicing practices in connection with an FTC probe to determine whether any subprime lenders, servicers or brokers had violated certain

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[446] E-mail dated Mar. 1, 2006, from Marianne Sullivan, Senior Vice President, Credit Loss Management.

[447] E-mail dated Mar. 16, 2006, from Nye Lavalle to Mark Cymrot.

[448] Attachment from e-mail dated Mar. 9, 2006 from Richard Bauerband, Director of Non-Traditional Servicing.

[449] Attachment from e-mail dated Mar. 7, 2006 from Richard Bauerband, Director of Non-Traditional Servicing. *See also* November 2, 2005, Moody's Servicer Report for EMC Mortgage Corporation and October 10, 2005, FitchRatings Residential Mortgage Servicer Report for EMC Mortgage Corp.

[450] Attachment from e-mail dated Mar. 9, 2006, from Richard Bauerband, Director of Non-Traditional Servicing.

[451] Telephone Interview with Robert Sanborn, Vice President, National Servicing Organization (Mar. 7, 2006). This group evaluates the financial and operational capacity of Fannie's lenders and servicers, and is comprised of three teams: Financial Analysis, Traditional Seller/Servicer Operational Review and Compliance, and Private Label ABS and Non-traditional Lender Reviews. Letter dated Feb. 7, 2006, from Lesia Bates Moss, Vice President, Single Family Mortgage Business Counterparty Risk Management, to Mark Cymrot.

consumer-protection laws.[452] Fitch continued to give EMC its highest ratings as a subprime and special servicer as of February 2, 2006, stating that the investigation was not sufficient to cause a rating change at that time.[453]

As for Ocwen, it services about 680 Fannie Mae accounts that are worth a total of $25 million, and subservices 400 Fannie Mae accounts worth $54 billion.[454] A servicing consultant visits the facility at least quarterly.[455] Fannie Mae has discovered no problems with its collection and servicing practices, but found that Ocwen was not remitting and depositing its principal and interest collections for Fannie Mae in a timely manner.[456] This problem affects Fannie Mae but not borrower balances. The National Servicing Organization will follow-up to resolve this issue.[457] Fannie Mae also is concerned by Ocwen's high outsourcing rate; more than 60 percent of Ocwen's full time employees are in its India operation.[458] Moody's gave Ocwen an above-average rating (SQ2-, which means it's at the lower end of that rating); S&P rated

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[452] *See, e.g.,* December 30, 2005, article "Bear Stearns Gets FTC Demand for Data on Mortgages (Update 2), available at http://www.bloomberg.com/apps/news?pid=10000103&refer=us&sid=amLFixectHw0#; "Fitch: Launch of FTC Investigation Does Not Warrant Rating Change for EMC," available at http://home.businesswire.com/portal/site/google/index.jsp?ndmViewId=news_view&newsId=20060206005939&newsLang=en.

[453] "Fitch: Launch of FTC Investigation Does Not Warrant Rating Change for EMC," available at http://home.businesswire.com/portal/site/google/index.jsp?ndmViewId=news_view&newsId=20060206005939&newsLang=en.

[454] Attachment from e-mail dated Mar. 9, 2006, from Richard Bauerband, Director of Non-Traditional Servicing.

[455] Attachment from e-mail dated Mar. 7, 2006, from Robert Sanborn, Vice President, National Servicing Organization.

[456] Attachment from e-mail dated Mar. 7, 2006, from Robert Sanborn, Vice President, National Servicing Organization.

[457] Telephone Interview with Robert Sanborn, Vice President, National Servicing Organization (Mar. 7, 2005).

[458] Attachment from e-mail dated Mar. 7, 2006, from Robert Sanborn, Vice President, National Servicing Organization.

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Ocwen as strong; and Fitch gave Ocwen its second highest rating for a primary servicer (RPS2).[459]

In November 2005, a Texas jury found that Ocwen committed fraud in servicing a $31,000 home-equity loan and awarded the plaintiff $11.5 million.[460] The judge dismissed a portion of the award, and entered a $1.8 million judgment against Ocwen, which Ocwen is asking the court to set aside.[461]

Litton services 350 Fannie Mae loans worth a total of $13.5 million for Fannie Mae's portfolio, and has no subservicing relationships.[462] A servicing consultant visits the facility at least quarterly, and most recently visited the site in January 2006.[463] An ABS operational review was conducted in May 2005.[464] Moody's has given Litton its highest rating as a servicer for subprime loans (SQ1); S&P rated Litton as strong; and Fitch gave Litton its highest rating for a subprime servicer (RPS1).[465] A large portion of the ARMs with an interest only feature that Litton services are expected to adjust in 2006, so Fannie Mae is monitoring the

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[459] Attachment to e-mail dated Mar. 9, 2006, from Richard Bauerband, Director of Non-Traditional Servicing. *See also* August 16, 2005, Moody's Servicer Report for Ocwen Loan Servicing, LLC and October 10, 2005, FitchRatings Residential Mortgage Servicer Report for Ocwen Financial Corporation.

[460] *See* "Florida Bank Hit With $11.5 Million Verdict; Galveston Jury Says Ocwen Federal Bank Forced Woman Into Bankruptcy," PR Newswire, available at http://sev.prnewswire.com/banking-financial-services/20051129/DATU03429112005-1.html.

[461] *See* Press Release, Yahoo!, "Ocwen Loan Servicing Seeks Reversal of a Galveston Court Decision, Reiterating Long-Standing Commitment to 'Win-Win' Loan Resolutions" available at http://biz.yahoo.com/pz/060213/93960.html.

[462] Attachment to e-mail dated Mar. 9, 2006, from Richard Bauerband, Director of Non-Traditional Servicing. Litton also services more than $1 billion worth of ABS in which Fannie has purchased bonds. Statistics on the amount of ABS that Fannie has invested in and EMC, Litton, and Ocwen service were not disclosed.

[463] Attachment from e-mail dated Mar. 7, 2006, from Robert Sanborn, Vice President, National Servicing Organization.

[464] *Id.*

[465] Attachment from e-mail dated Mar. 7, 2006, from Richard Bauerband, Director of Non-Traditional Servicing. *See also* November 22, 2005, FitchRatings Residential Mortgage Servicer Report for Litton Loan Servicing LP.

situation and conversing with it regarding their efforts to notify borrowers and what the effects of delinquency are.[466]

In July 2004, Fairbanks changed its name to Select Portfolio Servicing, Inc. ("SPS").[467] Credit Suisse First Boston ("CSFB") acquired SPS and its parent SPS Holding Corp. in October 2005.[468] At the time Fairbanks entered into the consent decree, it was the wholly-owned subsidiary of Fairbanks Capital Holding Corp.[469] Thus, the persons operating the company have changed.

SPS services about 3,500 Fannie Mae accounts worth $313.4 million, and subservices about 2,500 worth $267.8 million.[470] A servicing consultant visits the facility at least quarterly. A January 2006 review uncovered no servicing issues.[471] In 2005, Moody's gave SPS an above average rating as a primary servicer for subprime loans (SQ2-, meaning it's near the bottom of the above-average rating); S&P rated SPS as average; and Fitch gave SPS an average rating for a primary servicer (RPS2-).[472]

Fannie Mae reviewed and examined Fairbanks' servicing practices both before and after it entered into the consent order with FTC and HUD in late 2003.[473] Fairbanks was a

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[466] Attachment from e-mail dated Mar. 7, 2006, from Robert Sanborn, Vice President, National Servicing Organization.

[467] Fairbanks Capital Corp. Settles Federal Charges Of Law Violations, available at http://www.ftc.gov/fairbanks/.

[468] August 19, 2005, letter from Jeff Graham, SPS Licensing Specialist, Corporate Legal Department, to Fannie. *See also* E-mail dated Mar. 9, 2006, attachment from Rick Bauerband, Director of Non-Traditional Servicing.

[469] Press Release, FTC, Fairbanks Capital Settles FTC and HUD Charges, available at http://www.ftc.gov/opa/2003/11/fairbanks.htm. Both Fairbanks and Fairbanks Capital Holding Corp. entered into the consent decree.

[470] *Id.*

[471] E-mail dated Mar. 7, 2006, attachment from Robert Sanborn, Vice President, National Servicing Organization.

[472] Attachment from E-mail dated Mar. 7, 2006, from Richard Bauerband, Director of Non-Traditional Servicing. *See also* February 28, 2006, Moody's Servicer Report for Select Portfolio Servicing, Inc. and August 12, 2005, FitchRatings Residential Mortgage Servicer Report for Select Portfolio Servicing.

[473] Telephone Interview with Zach Oppenheimer, Senior Vice President, Single Family Mortgage Business (Mar. 6, 2006). *See also,* Austin Business Journal, "Austin Mortgage Firm Merging with Utah Company," (May 10, 2002).

subservicer for CSFB, which delivered bulk loans to Fannie Mae.[474] In late 2002, Fairbanks purchased Olympus Servicing LP from DLJ Mortgage Capital, an affiliate of CSFB.[475] Olympus had serviced loans that DLJ Mortgage Capital sold to Fannie Mae.[476] Around the same time, elected officials and community groups began to complain about some of Fairbanks' practices, and Fannie Mae discovered that the loans that Fairbanks was servicing for CSFB did not perform as well as they should.[477] Fannie Mae reviewed CSFB and Fairbanks' subservicing operations.[478] In April 2003, after CFSB had audited Fairbanks' servicing practices, Fannie Mae began to more thoroughly examine Fairbanks by sending employees to investigate their operations.[479] The employees discovered numerous problems with Fairbanks' servicing practices.

In May 2003, Fairbanks released its senior management team.[480] Later that month, Fannie Mae sent a letter to Fairbanks outlining its concerns and stating that Fairbanks agreed not to attempt to sell or deliver any loans to Fannie Mae or add to the portfolio of loans it was servicing for Fannie Mae, with limited exceptions, until it corrected the problems.[481] The letter also required Fairbanks to immediately cease assessing improper charges and to reimburse

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[474] Telephone Interview with Sam Smith, Vice President, Single-Family Operations, Eastern Business Center (Mar. 6, 2006).

[475] *Id.*

[476] *Id.*

[477] Telephone Interview with Zach Oppenheimer, Senior Vice President, Single Family Mortgage Business (Mar. 6, 2006).

[478] *Id.*

[479] Telephone Interview with Sam Smith, Vice President, Single-Family Operations, Eastern Business Center (Mar. 6, 2006).

[480] Telephone Interview with Sam Smith, Vice President, Single-Family Operations, Eastern Business Center (Mar. 6, 2006).

[481] *See* May Letter from Zach Oppenheimer, Senior Vice President, Single Family Mortgage Business, to Fairbanks Capital Corporation (May 23, 2003).

any borrowers for improper fees it charged them.[482] At that time, Fairbanks was servicing $7.9 billion worth of Fannie's loans.[483] Fairbanks' new management team cooperated with Fannie Mae and created a 40-point plan that addressed the issues that Fannie Mae identified, plus others.[484] Fannie Mae has continued to work closely with Fairbanks to resolve the issues identified and to verify that they have been corrected.[485]

E. Impact of Fannie Mae's Loan Repurchase Policy

Mr. Lavalle claims that when Fannie Mae rejects a loan for purchase, it is labeled "scratch and dent" and transferred to an aggressive or predatory servicer, which drives the loan into default and the borrower into bankruptcy. Mr. Lavalle contends this practice will result in liability for Fannie Mae. Mr. Lavalle wants Fannie Mae to warn borrowers that their loans have been rejected and are going to an aggressive servicer.

Fannie Mae's Selling Guide establishes financial parameters for the types of mortgages it accepts for purchase.[486] It can reject loans that do not meet the requirements.[487] Some requirements are non-negotiable while others Fannie Mae is willing to negotiate. For instance, Fannie Mae can purchase only those loans that are within its loan limits, which may be adjusted each year.[488] Fannie Mae, however, allows variances for other requirements, enabling certain large lenders to sell Fannie Mae loans that do not meet the requirements set forth in the

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[482] *Id.*

[483] Telephone Interview with Sam Smith, Vice President, Single-Family Operations, Eastern Business Center (Mar. 6, 2006).

[484] *Id.*

[485] Telephone Interview with Robert Sanborn, Vice President, National Servicing Organization (Mar. 7, 2006).

[486] *See* Selling Guide VII-104.03.

[487] Interview with John Gang, Vice President, Asset Acquisitions and Custody (Dec. 8 2005).

[488] *See* Federal National Mortgage Association Charter Act, Sec. 302(b)(2), 12 U.S.C. § 1717. The loan limit for a single-family mortgage is $417,000 for 2006. See News Release, Fannie Mae (Nov. 29, 2005), at www.fanniemae.com/newsreleases/2005/3649.jhtml?p=Media&s=News+Releases.

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Selling Guide.[489] About five percent of the loans lenders sell to Fannie Mae for its portfolio have variances, and about 40 percent of the loans lenders sell for MBS have variances.[490] In these cases, the lenders have implemented additional policies and procedures that make loans that fall outside of Fannie Mae's guidelines less risky than usual, and thus Fannie Mae is willing to purchase them.[491] Lenders rarely attempt to sell Fannie Mae loans that do not meet Fannie Mae's guidelines or that Fannie Mae has not approved to purchase in a separate contract.[492]

Fannie Mae, however, requires lenders to repurchase loans in some circumstances.[493] Repurchases can arise for a variety of reasons. For instance, mortgages in a portfolio or MBS pool violate a contractual selling warranty; improper servicing of a portfolio mortgage has materially adverse effects on the value of a mortgage or property; an adjustable-rate mortgage in an MBS pool is converted to a fixed-rate mortgage, or an MBS pool mortgage that has 24 payments past due. As an alternative to the repurchase, some mortgages will be transferred from an MBS pool to Fannie Mae's portfolio.[494] The number of repurchases has been fairly minor in recent years. A fraud team in Fannie Mae's National Underwriting Center

[489] Interview with John Gang, Vice President, Asset Acquisitions and Custody (Dec. 8, 2005). *See also* Single-Family MBS Prospectus, January 1, 2006, p. 41 (stating "We also may waive or modify our eligibility and loan underwriting requirements or policies when we purchase mortgage loans.").

[490] Interview with John Gang, Vice President, Asset Acquisitions and Custody (Dec. 8, 2005).

[491] *Id.* For instance, the lenders may require the borrowers to provide more paychecks as evidence of employment than they ordinarily would for less risky types of loans, or the lenders may conduct a more thorough house inspection than it ordinarily would.

[492] *Id.*

[493] Selling Guide, I-208. *This section of the Selling Guide was updated January 31, 2006.* Fannie Mae "clarified [its] policies concerning when lenders may (or must) repurchase a loan from [its] portfolio or their MBS pool, and [its] removal of delinquent special servicing MBS loans by reclassification of such loans as Fannie Mae portfolio loans."

[494] Selling Guide, I-208. It states: "We will not require the immediate repurchase of a mortgage when we identify significant underwriting deficiencies during a post-purchase review—as long as the mortgage is current, was not originated based on fraud or misrepresentation, and is not in violation of our mortgage eligibility requirements (including any applicable selling warranties) ***and*** the lender that sold the mortgage (or is now servicing it) is in good standing with us and is otherwise eligible to receive our 'no-repurchase-of-performing-mortgages' exemption (as discussed in *Section 208.08*). Should the mortgage later become delinquent, we will review the individual circumstances to determine whether repurchase is warranted at that time. ..."

reviews a subset of the mortgages that Fannie Mae purchases or securitizes to ensure that they meet Fannie Mae's eligibility criteria and underwriting standards.[495] If they do not, Fannie Mae can require lenders to repurchase them.[496]

From 2002 to 2004, lenders repurchased about 10,000 loans, worth about $1.1 billion, that they had sold to Fannie Mae.[497] Fannie Mae owned an average of 15.2 million loans worth about $1.8 trillion during that period.[498]

F. Findings Regarding Predatory Servicing

Fannie Mae officials are sensitive to the issues raised by predatory lending and servicing. Fannie Mae has extensive rules and procedures to protect borrowers, and those procedures have been augmented in recent years. Mr. Lavalle's suggestion that Fannie Mae adopt "best practices" procedures modeled after the Fairbanks consent order has already been implemented. In 2004, Fannie Mae issued three circulars setting forth extensive additional servicing requirements after reviewing the Fairbanks order. In the view of Fannie Mae officials, the consent order requirements were not entirely appropriate for its universe of servicers, which are generally not working in the subprime markets. When Fannie Mae departed from the Fairbanks requirements, it often gave its servicers more discretion to deal with borrowers.

Mr. Lavalle has proposed a "best practices" model that goes even further than the Fairbanks consent order. His proposals would appear to increase the cost of servicing

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[495] *Id.*

[496] Interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Nov. 22, 2005).

[497] Repurchases Chart, E-mail dated Mar. 1, 2006, with attachment from Marianne Sullivan. This figure reflects the active and foreclosed loans that lenders repurchased from Fannie Mae. It does not include cases in which upon foreclosure Fannie Mae sells the real-estate-owned ("REO") it acquired after foreclosure. In those cases, Fannie Mae may seek reimbursement on the loss because it had requested the lender repurchase the loan; these are referred to as make wholes and are not included in the figure above.

[498] All Active Single-Family Loans Chart, E-mail dated Mar. 1, 2006, with attachment from Marianne Sullivan, Senior Vice President, Credit Loss Management.

considerably and might not increase significantly borrower safety. Without additional evidence that Fannie Mae's servicers are acting improperly, we find that Fannie Mae has adopted practices that are consistent with the law and reasonably designed to prevent predatory servicing.

The financial parameters Fannie Mae establishes for purchasing loans or for establishing MBS pools are essential to its financial health. Enforcing those requirements by requiring lenders to repurchase loans that do not conform to the parameters or have other issues is essential and complies with basic contract requirements. In our view, Mr. Lavalle has not presented evidence that repurchased loans will necessarily be improperly serviced and borrowers injured.

Predatory servicing outside the universe of Fannie Mae servicers is an issue that has gained considerable attention from federal and state regulators in recent years. Fannie Mae should police servicers on its mortgages, but it is not in a position to police servicers when it requires the repurchase of loans. That function is best served by government regulators and civil lawsuits. Mr. Lavalle's proposal that Fannie Mae inform borrowers whenever it requires the repurchase of loans is impractical and unnecessary, except to the extent fraud has been discovered, which is discussed separately.

VI.
FRAUD INVESTIGATIONS AND REPORTING

A. Mr. Lavalle's Concerns Regarding Fannie Mae's Fraud Procedures

Mr. Lavalle believes that Fannie Mae has an ethical obligation to inform borrowers of any fraud that it discovers involving their loans.[499] He claims that loan originators and mortgage servicers often discover fraud in their due diligence and quality control

[499] E-mail from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors (July 22, 2005).

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processes.[500] He states that these frauds are reported to MARI (Mortgage Asset Research Institute, Inc.), an industry database, but questions whether borrowers are ever informed of the fraud.[501]

B. OFHEO's Mortgage Fraud Reporting Regulation

Fannie Mae's focus on detecting mortgage fraud has increased significantly in the past several years. OFHEO requires Fannie Mae to report mortgage fraud or possible mortgage fraud to it. Fannie Mae has been submitting fraud reports since September 2005. Fannie Mae, however, does not report possible mortgage fraud directly to borrowers under the OFHEO procedures.[502]

Under the Mortgage Fraud Reporting regulation,[503] mortgage fraud is defined as "a material misstatement, misrepresentation, or omission relied upon by [Fannie Mae] 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 [Fannie Mae]."[504] Possible mortgage fraud "means that [Fannie Mae] has a reasonable belief, based upon a review of information available to [Fannie Mae], that mortgage fraud may be occurring or has occurred."[505]

Under the OFHEO rule, Fannie Mae is required to report mortgage fraud or possible mortgage fraud to OFHEO when it:

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[500] *Id.*

[501] *Id.*

[502] Interview with Marianne Sullivan, Senior Vice President, Credit Loss Management (Nov. 16, 2005); Interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Nov. 22, 2005).

[503] 12 C.F.R. § 1731.

[504] 12 C.F.R. § 1731.2(c). It states that "[s]uch 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."

[505] 12 C.F.R. § 1731.2(e).

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> a. Identifies that a board member, officer, employee, or contractor engaged by [Fannie Mae] has or may have perpetrated such fraud.
>
> b. Identifies institutional (seller/servicer) fraud, such as lack of collateral, theft of custodial funds, non-remittance of pay-off, or multiple delivery of same loan.
>
> c. Receives notification by law enforcement or other governmental authority that such authority is conducting an investigation or prosecution of mortgage fraud involving loans owned by [Fannie Mae], absent a legal directive from such authority not to report such fraud.
>
> d. Identifies a pattern of related mortgage fraud or possible mortgage fraud as defined under reviewable internal procedures or standards.
>
> e. Identifies that there is a substantial likelihood that the mortgage fraud or possible mortgage fraud will receive significant public exposure or publicity.
>
> f. Identifies mortgage fraud or possible mortgage fraud that is otherwise serious or significant to [Fannie Mae].[506]

In addition, Fannie Mae "may not require the repurchase of or may not decline to purchase a mortgage, mortgage backed security, or similar financial instrument because of possible mortgage fraud without promptly reporting to the Director [of OFHEO] under § 1731.4. [Fannie Mae] may decline such purchase or require such repurchase if it is reporting mortgage fraud or possible mortgage fraud in accordance with § 1731.4."[507]

In order to fulfill its reporting duties, Fannie Mae must submit a Mortgage Fraud Incident Notice ("MFIN") to OFHEO's Examiner-in-Charge for Fannie promptly after it identifies or is notified by authorities of mortgage fraud or possible mortgage fraud, but not more

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[506] OFHEO Director's Advisory, Policy Guidance, Issuance Date: July 25, 2005, Subject: Examination for Mortgage Fraud Reporting.

[507] 12 C.F.R. § 1731.3.

than ten days after such identification or notification.[508] In situations requiring immediate attention – such as "where [Fannie Mae] has identified that there is a substantial likelihood that the mortgage fraud or possible mortgage fraud will receive significant public exposure or publicity; where [Fannie Mae] has received notification by a law enforcement or other authority that such authority is conducting an investigation or prosecution of mortgage fraud involving loans owned by [Fannie Mae]; or where [Fannie Mae] has identified that mortgage fraud or possible mortgage fraud may have a significant impact on the safe and sound operations of [it]" – Fannie Mae must immediately notify OFHEO's Examiner-in-Charge for Fannie Mae by telephone or electronic communication.[509] This report is in addition to submitting a MFIN. Fannie Mae also must submit to the Examiner-in-Charge a quarterly report on the status of cases submitted in the quarter on the MFIN.[510]

Once a MFIN has been submitted, Fannie Mae and Freddie Mac "may *not* disclose, without the prior written approval of the Director, to the party or parties connected with the mortgage fraud or possible mortgage fraud that it has reported such fraud . . . ."[511] Fannie Mae and Freddie Mac, however, are not prohibited from "[d]isclosing or reporting such fraud pursuant to legal requirements, including reporting to appropriate law enforcement or other governmental authorities; or [t]aking any legal or business action it may deem appropriate, including any action involving the party or parties connected with the mortgage fraud or possible

[508] OFHEO Director's Advisory, Policy Guidance, Issuance Date: July 25, 2005, Subject: Examination for Mortgage Fraud Reporting. *See also* 12 C.F.R. pt. 1731.4, requiring Fannie Mae and Freddie to "report promptly mortgage fraud or possible mortgage fraud in writing to the Director in such format and under such notification procedures as prescribed by OFHEO."

[509] OFHEO Director's Advisory, Policy Guidance, Issuance Date: July 25, 2005, Subject: Examination for Mortgage Fraud Reporting.

[510] *Id.*

[511] 12 C.F.R. § 1731.4(c).

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mortgage fraud."[512] Fannie Mae "does not waive any privilege it may claim under law by reporting mortgage fraud or possible mortgage fraud . . . ."[513]

Under the new OFHEO regulation, Fannie Mae also must "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 . . . ."[514] The system should include at least the following types of controls and procedures:

> 1. *Mortgage fraud officer.* Designation of a management official with overall responsibility for the mortgage fraud detection, investigation, and reporting system ("mortgage fraud officer");
>
> 2. *Central reporting point.* A central point to report mortgage fraud;
>
> 3. *Central repository(ies).* Central repositories for mortgage fraud information;
>
> 4. *Continued business.* Designation of the mortgage fraud officer(s) or senior management officer(s) to approve any continued business with any person or entity suspected of mortgage fraud;
>
> 5. *Internal publication.* Internal publication of the mortgage fraud reporting procedures and anti-fraud policies;
>
> 6. *External publication.* External publication of the Enterprise's contacts to receive notices or tips of mortgage fraud; and
>
> 7. *Other.* Such other standards as provided by OFHEO.[515]

In addition, Fannie Mae's Board of Directors, or a committee of the Board, "shall cause [Fannie Mae] to conduct a review of the anti-fraud detection, investigation, and reporting policies at least annually, and shall document its consideration of the results of that review in the minutes of the

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[512] *Id.*

[513] 12 C.F.R. §1731.4(e).

[514] 12 C.F.R. § 1731.5.

[515] OFHEO Director's Advisory, Policy Guidance, Issuance Date: July 25, 2005, Subject: Examination for Mortgage Fraud Reporting.

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Board or Board committee."[516] The Mortgage Fraud Reporting rule contains sanctions pursuant to which OFHEO "may subject the Enterprise or [its] board members, officers, or employees ... to supervisory action ... under the Federal Housing Enterprises Safety and Soundness Act of 1992 (12 U.S.C. §§ 4501-4641), including but not limited to, cease-and-desist proceedings and civil money penalties."[517]

C. Fannie Mae's Implementation of Fraud Detection and Reporting Measures

1. Internal Practices

Fannie Mae recently implemented policies to help it detect and prevent fraud. In 2004, it created a corporate Anti-Fraud Policy that requires its employees to report possible fraud.[518] The Policy broadly defines fraud as including "any intentional act or omission affecting or involving, or potentially affecting or involving, Fannie Mae, that is committed or attempted for the purpose of securing an improper or unlawful gain or benefit for Fannie Mae or any other individual or entity, regardless of whether the gain or benefit is actually realized."[519] The definition applies even if the act or omission does not meet the legal definition of fraud.[520]

The policy requires the managers of business units to identify and evaluate activities that create risks for fraud within their business unit, and implement fraud prevention and detection measures.[521] The measures include notifying the Office of Corporate Compliance ("OCC") or the Office of Corporate Justice ("OCJ") when potential fraud is discovered, and

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[516] *Id.*

[517] 12 C.F.R. § 1731.6.

[518] Single Family Anti-Fraud Protocols and Procedures, p. 1. *See also* Code of Business Conduct/Policies, Mortgage Fraud Reporting, What you need to know (available on Fannie Mae's internal website).

[519] Policies and Procedures, Anti-Fraud (available on Fannie Mae's internal website). *See also* Single Family Anti-Fraud Protocols and Procedures, p. 1.

[520] Policies and Procedures, Anti-Fraud.

[521] *Id.*

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changing any prevention or monitoring systems that allowed fraud to occur.[522] The OCC and OCJ are part of the Office of Corporate Compliance, Ethics and Investigations.[523] The Policy also requires managers to tell all employees in their business units about the anti-fraud measures and incorporate them into their unit's compliance plan, which they previously developed with the OCC.[524] The compliance plans include an Anti-Fraud Matrix that details the controls in place to protect against certain identified fraud scenarios.[525]

When the OCC or OCJ receives a report of fraud, they consult with each other to determine whether the alleged fraud raises a viable claim of fraud under the Anti-Fraud Policy.[526] If it does, the OCJ notifies the Chief Compliance Officer, the General Counsel, and the Office of Auditing and Operations Risk, and directs prompt action to ensure that it does not involve Fannie Mae and that Fannie Mae does not derive any improper gain from the activity, and/or it conducts an investigation to determine whether fraud has occurred.[527] The OCJ must notify the OCC, the Chief Compliance Officer, the General Counsel, and the Office of Auditing and Operations Risk of all findings and any actions taken as a result of the investigation.[528] The General Counsel regularly notifies the Board of Directors of any findings of fraud, and all investigations and findings of investigations of alleged fraud that may involve a Fannie Mae officer.[529]

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[522] *Id.*

[523] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Mar. 3, 2006).

[524] Policies and Procedures, Anti-Fraud.

[525] Single Family Anti-Fraud Protocols and Procedures, p. 3; Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 28, 2006).

[526] Policies and Procedures, Anti-Fraud.

[527] *Id.*

[528] *Id.*

[529] *Id.*

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Under the Anti-Fraud Policy, "every employee has the responsibility to report information he or she may receive or possess about possible fraud, including possible mortgage fraud."[530] Examples of possible mortgage fraud that employees must report "include, but are not limited to:

- Patterns of inflated appraisals or false documentation,
- Instances in which an institution such as a seller/sevicer is involved in the possible fraud,
- Knowledge that a law enforcement agency is conducting an investigation, or
- A substantial likelihood that the possible mortgage fraud will receive significant publicity."[531]

Employees who have information about possible mortgage fraud must report it internally to a mortgage fraud tips e-mailbox, a Fannie Mae officer, the OCJ, or the OCC.[532] These individuals, in turn, must send the information to the Single Family Anti-Fraud Team ("Anti-Fraud Team"), which is responsible for collecting all information or tips regarding possible mortgage fraud, and managing the internal and external reporting of the possible fraud.[533] The Anti-Fraud Team also administers the mortgage fraud tips e-mailbox.[534]

The Single Family Mortgage Business division developed its own anti-fraud procedures in 2005.[535] The Single Family Anti-Fraud Protocols and Procedures ("Protocols and

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[530] Code of Business Conduct/Policies, Mortgage Fraud Reporting, What you need to know (available on Fannie Mae's internal website).

[531] *Id.*

[532] *Id.*

[533] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 27, 2006). *See also* Anti-Fraud Policy and Program, October 25, 2005, p. 5. The Single Family Anti-Fraud Team previously belonged to the National Underwriting Center, but is now a separate group in the Single Family Mortgage Business division.

[534] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule.

[535] *See* Single Family Anti-Fraud Protocols and Procedures, p. 1.

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Procedures") explain how the corporate Anti-Fraud Policy applies to the division.[536] The Protocols and Procedures focus on two categories of mortgage fraud – institutional fraud and loan level fraud.[537] Institutional fraud is "intentional fraud that is perpetrated by or with the cooperation of a Fannie Mae approved seller or servicer of mortgages or one or more representatives of a Fannie Mae approved seller or servicer."[538] It includes the sale of fraudulent loans or double selling loans, and mortgage servicers' misappropriation or mishandling of escrow funds or custodial accounts.[539] Loan level fraud, on the other hand, "involves intentional material misrepresentation by one or more parties to the loan transaction," and includes falsifying documents related to employment or assets, property flipping, valuation fraud, and borrower identity theft.[540]

Under the Protocols and Procedures, just as under the corporate Anti-Fraud Policy, each Single Family Mortgage Business unit is responsible for identifying activities that create risks for fraud, implementing prevention and detection measures, and creating compliance plans and Anti-Fraud Matrixes.[541] Fourteen business units in the Single Family Mortgage

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[536] *Id.* at 1.

[537] *Id.* at 2.

[538] *Id.*

[539] *Id.*

[540] *Id.*

[541] *Id.* at 3.

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Business division completed Anti-Fraud Matrixes in 2005.[542] The division has since reorganized its structure, and the Anti-Fraud Matrixes will be updated this year to reflect those changes.[543]

In order for a business unit to discontinue or change any anti-fraud control in its compliance plan, the officer who manages the business unit must approve the change, notify the Vice President of Single Family Anti-Fraud Initiatives in writing, and ensure that the OCC Director assigned to that business unit agrees with the change.[544] The Anti-Fraud Matrix is then modified to reflect the change.[545]

Each business unit must periodically test the anti-fraud controls described in their Anti-Fraud Matrix, using simulated scenarios when practicable, in order to evaluate the measures.[546] The Protocols and Procedures state that the measures are to be reviewed and revised on a quarterly basis.[547] Measures related to Sarbanes-Oxley ("SOX") are currently being tested by PWC and Fannie Mae's outside auditor, Deloitte and Touche.[548] PWC is consulting with the Office of Corporate Compliance, Ethics and Investigations to develop a process for testing SOX and non-SOX related measures, and plans to implement the process this year.[549]

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[542] They were: Business and Product Development; Credit and Automated Underwriting; National Servicing Center; National Underwriting Center; National Property Disposition Center; Anti-Fraud Initiatives; Eastern Business Center; National Business Center; Western Business Center; Lender Channel; Investor Channel; eChannel; Lender Strategies and Management; and Specialty Lending - Manufactured Housing. E-mail from Peter Kopperman, Vice President for Anti-Fraud Initiatives, to Ambika Biggs (Feb. 28, 2006).

[543] Telephone interview with Peter Kopperman (Feb. 28, 2006), Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business; E-mail from Peter Kopperman, Vice President for Anti-Fraud Initiatives, to Ambika Biggs (Feb. 28, 2006).

[544] Single Family Anti-Fraud Protocols and Procedures, p. 4.

[545] *Id.*

[546] *Id.* at 3.

[547] *Id.* at 3.

[548] E-mail dated Mar. 3, 2006, from Peter Kopperman, Vice President, Anti-Fraud Initiatives, to Ambika Biggs.

[549] *Id.*

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The Protocols and Procedures require Single Family Mortgage Business employees to notify the Anti-Fraud Team if they receive or identify information that leads them to suspect that institutional or loan level fraud has occurred.[550] The procedures regarding how the Anti-Fraud Initiatives unit – which includes the Anti-Fraud Team, the Vice President of Anti-Fraud Initiatives, the Director of Anti-Fraud Initiatives,[551] and the Manager of Fraud Reporting[552] – shares that information with other Fannie Mae management personnel.[553]

First, the Anti-Fraud Team determines whether the suspected fraud involves Fannie Mae loans or a Fannie Mae seller or servicer.[554] If neither Fannie Mae loans nor a Fannie Mae seller or servicer is involved, the Anti-Fraud Team logs the information onto a Watch List so future related patterns can be identified.[555] However, if the information is specific in terms of the loans, lenders or parties affected, the Director of Anti-Fraud Initiatives and the Manager of Fraud Reporting notify the Vice President of Anti-Fraud Initiatives and the attorney for the Office of Corporate Compliance, regardless of whether the suspected fraud involves Fannie Mae loans or lenders.[556] In cases in which a Fannie Mae seller or servicer is involved, but Fannie Mae loans are not involved, the Anti-Fraud Team sends the information to the Vice President of Single Family Operations responsible for that entity so that it can investigate whether the entity

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[550] Single Family Anti-Fraud Protocols and Procedures, p. 6.

[551] Bill Brewster currently fills this position.

[552] Jane Everett currently fills this position.

[553] Telephone interview with Peter Kopperman, President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Mar. 3, 2006).

[554] Single Family Anti-Fraud Protocols and Procedures, p. 8. The Single Family Anti-Fraud Protocols and Procedures state that the NUC Fraud Team makes this determination. The Single Family Anti-Fraud Team previously belonged to the National Underwriting Center, but is now a separate group in the Single Family Mortgage Business division. The Anti-Fraud Team still uses the procedures that the NUC Fraud Team created. Interview with Bill Brewster, Director, Anti-Fraud Initiatives (Nov. 7, 2005).

[555] Single Family Anti-Fraud Protocols and Procedures, p. 8.

[556] Telephone interview with Peter Kopperman, President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Mar. 3, 2006). *See also* Single Family Anti-Fraud Protocols and Procedures, p. 8.

has operational or other risk issues that need to be addressed, or whether the case involves institutional fraud.[557]

If Fannie Mae loans are involved, the Vice President of Anti-Fraud Initiatives notifies the Vice President of Single Family Operations for the location of the seller or servicer; the Vice President and Deputy General Counsel, SWRO; the OCC; the OCJ; the Chief Compliance Officer; the Senior Vice President of Credit Loss Management and Quality Assurance; the Senior Vice President of the location; the Single Family Credit Officer; the Chief Risk Officer; the location Vice President of Marketing; and the Director of News and Public Affairs.[558] The Anti-Fraud Team then investigates.[559] In cases of suspected pattern fraud, the Anti-Fraud Team and Vice President for Single Family Operations conduct a preliminary review to determine if there is evidence of suspected fraud, and the Vice President and Deputy General Counsel, SWRO reviews this.[560] In cases of suspected institutional fraud, the Anti-Fraud Team works with the Vice President of Single Family Operations, the Vice President and Deputy General Counsel, SWRO and the Vice President of Single Family Anti-Fraud Initiatives.[561]

As explained above, under the corporate Anti-Fraud Policy, when the OCJ and OCC receive reports of fraud, they consult with each other to determine if the reported activity raises a claim of fraud under the Policy.[562] They then communicate their determination to the Chief Compliance Officer; the Office of Auditing and Operations Risk; the Vice President and Deputy General Counsel, SWRO; the Vice President of Anti-Fraud Initiatives; the Director of

[557] Single Family Anti-Fraud Protocols and Procedures, p. 8.

[558] Telephone interview with Peter Kopperman, President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Mar. 3, 2006).

[559] *Id.*

[560] Single Family Anti-Fraud Protocols and Procedures, p. 8.

[561] *Id.* at 8.

[562] *Id.* at 13; Policies and Procedures, Anti-Fraud.

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Anti-Fraud Initiatives; the Vice President of Single Family Operations; and the General Counsel.[563] If the report of possible fraud involves misrepresentation on a single loan or on multiple loans that do not appear to be part of institutional or pattern mortgage fraud, or if the OCJ does not designate the report as stating a viable claim of fraud, then the Vice President of Single Family Operations determines the appropriate business remedy.[564] In cases in which the lender's relationship with Fannie Mae may be altered, or if repurchase is the remedy and the lender cannot or will not repurchase the loans, legal counsel for the location must be consulted.[565] The Vice President and Deputy General Counsel and Chief Compliance Officer must be notified and provided an opportunity to provide input in those cases.[566]

If the OCJ determines that a viable claim of institutional or pattern fraud exists, the Vice President of Single Family Anti-Fraud Initiatives, the Vice President of Single Family Operations and other staff from that location work together, with input from the Vice President and Deputy General Counsel, SWRO, to recommend the best business remedy and provide input on possible legal remedies.[567]

The Senior Vice President of Internal Audit provides the Board of Directors' Audit Committee with a monthly report of all mortgage fraud incidents that occurred.[568] In addition, each month the Interim Vice President for Operational Risk Oversight in the Corporate Chief Credit Officer organization reports all losses that occurred in the Single Family division to

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[563] Single-Family Anti-Fraud Protocols and Procedures, p. 13; Telephone interview with Peter Kopperman, Single Family Vice President of Anti-Fraud Initiatives (Mar. 3, 2006).

[564] Single-Family Anti-Fraud Protocols and Procedures, p. 14.

[565] *Id.*

[566] *Id.*

[567] *Id.*

[568] Telephone interview with Peter Kopperman, Single Family Vice President of Anti-Fraud Initiatives (Mar. 3, 2006).

the Board of Directors, including losses related to mortgage fraud.[569] These losses are contained in loss incident reports. Each time the Anti-Fraud Team discovers possible fraud, it sends a loss incident report to its Compliance Business Unit Interface, who in turn submits it to the Director for Single Family Operational Risk Management. The Director compiles all the loss incident reports for Single Family and submits them to the Interim Vice President for Operational Risk Oversight, who reports them to the Board of Directors.[570]

The Anti-Fraud Team also plans to begin issuing monthly reports in April 2006 that include status updates on its investigations of suspected fraud, material misrepresentations or serious misconduct.[571] It will follow the procedure already included in the Protocols and Procedures, which states that the reports are sent to: OCC; OCJ; Chief Compliance Officer; General Counsel; Single Family Vice President of Operations; Single Family Vice President of Servicing; Single Family Vice President of Anti-Fraud Initiatives; Servicing, Risk and/or Underwriting Directors; Director of Corporate Risk and Insurance; location counsel; Vice President and Deputy General Counsel, SWRO; Senior Vice President of Credit Loss Management and Quality Assurance; Single Family Credit Officer; Chief Risk Officer; and Director of News and Public Affairs.[572]

The Anti-Fraud Initiatives unit is working with the Chief Compliance Officer and external consultants to conduct a thorough review of Fannie Mae's anti-fraud program.[573] It

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[569] E-mail dated Mar. 2, 2006, from Peter Kopperman, Single Family Vice President of Anti-Fraud Initiatives.

[570] *Id.*

[571] Single Family Anti-Fraud Protocols and Procedures, p. 9. Telephone interview with Bill Brewster, Director of Anti-Fraud Initiatives (Mar. 1, 2006).

[572] Single Family Anti-Fraud Protocols and Procedures, pp. 9-10; Telephone interview with Bill Brewster, Director of Anti-Fraud Initiatives (Mar. 1, 2006).

[573] Next Steps for Anti-Fraud Initiatives, contained in the October 25, 2005 document entitled Anti-Fraud Policy and Program, prepared by Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business [hereinafter Next Steps for Anti-Fraud Initiatives] .

anticipates the results of that review to be available in the second quarter of this year.[574] The unit also plans to develop a technology platform and repository in order to centrally track mortgage fraud tips, manage fraud cases, and report to management and OFHEO.[575] It expects the system to be completed by the fourth quarter of this year.[576] In addition, it plans to update the Protocols and Procedures so they apply to a broader corporate audience and reflect the recent changes in procedures, and to provide the corresponding training.[577]

2. Reporting to OFHEO

In addition to reporting mortgage fraud internally, Fannie Mae has undertaken extensive efforts to implement the new OFHEO fraud rules for single family mortgages. Fannie Mae has been required to report possible mortgage fraud to OFHEO under the Mortgage Fraud Reporting rule since August 29, 2005.[578] The Anti-Fraud Team is responsible for notifying OFHEO of possible mortgage fraud for the Single Family Mortgage Business division.[579]

The Anti-Fraud Team collects information related to possible mortgage fraud, analyzes it, and determines whether it must be reported to OFHEO under the rule.[580] The Anti-Fraud Team

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[574] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 28, 2006).

[575] Next Steps for Anti-Fraud Initiatives.

[576] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 28, 2006).

[577] Next Steps for Anti-Fraud Initiatives. Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Mar. 3, 2006).

[578] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 27, 2006).

[579] National Underwriting Center (NUC) Fraud Team Procedures for Reporting Mortgage Fraud and Possible Mortgage Fraud to OFHEO. The NUC Fraud Team has been renamed the Single-Family Anti-Fraud Team. Fannie Mae has separate policy and procedures for reporting mortgage fraud or possible mortgage fraud for its Housing and Community Development business. *See* Business Process Model, section i. in the Mortgage Fraud Reporting Implementation September 2005 report to OFHEO ("Business Process Model").

[580] National Underwriting Center (NUC) Fraud Team Procedures for Reporting Mortgage Fraud and Possible Mortgage Fraud to OFHEO.

consists of the Reporting Team, Investigation Team, and Team Management.[581] The Reporting Team reviews information submitted by Fannie Mae employees and external parties regarding suspected mortgage fraud. The procedures Fannie Mae employees use to submit information regarding mortgage fraud was detailed in the section on internal reporting. Consumers also can submit mortgage fraud tips to the e-mailbox or via a toll-free number.[582]

If the Reporting Team determines that it has reasonable grounds to suspect fraud, it assigns an investigator from the Investigation Team to examine the information.[583] Fannie Mae only reports patterns of ten or more loans that contain possible fraud and have some other commonality.[584] After the Investigation Team initiates investigation, the Reporting Team determines whether the case must be reported to OFHEO, and if so, whether it must be reported immediately.[585] The Anti-Fraud Team has discretion regarding the timing of reports. If the Reporting team determines that the information must be reported to OFHEO immediately, it notifies OFHEO and then drafts a MFIN.[586] If it does not have to be reported immediately, the Reporting Team drafts the MFIN and the Manager of Fraud Reporting notifies the following individuals that the MFIN is ready for review:[587] Vice President, Anti-Fraud Initiatives; Director,

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[581] *See* Business Process Model.

[582] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule; Single-Family Anti-Fraud Protocols and Procedures, p. 6.

[583] Business Process Model, Flowchart 1.1 – Single-Family – Collect Fraud Information and Draft MFIN Form Process.

[584] Interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Nov. 22, 2005).

[585] Business Process Model, Flowchart 1.1 – Single-Family – Collect Fraud Information and Draft MFIN Form Process.

[586] Business Process Model, Flowchart 1.1 – Single-Family – Collect Fraud Information and Draft MFIN Form Process.

[587] National Underwriting Center (NUC) Fraud Team Procedures for Reporting Mortgage Fraud and Possible Mortgage Fraud to OFHEO. *See also* Business Process Model, Flowchart 1.1 – Single-Family – Collect Fraud Information and Draft MFIN Form Process.

Anti-Fraud Initiatives; and Associate Counsel, Office of Corporate Compliance.[588] The reviewers determine whether the MFIN is applicable and accurate, insert appropriate comments, and approve the MFIN once their review is complete.[589]

After each reviewer has approved the MFIN, the Team Management, which consists of the Manager of Fraud Reporting, Vice President of Anti-Fraud Initiatives and Director of Anti-Fraud Initiatives, notifies the National Underwriting Center Systems Team that the MFIN is ready for submission to OFHEO.[590] The Systems Team then sends the MFIN to OFHEO, the Office of Regulatory Compliance and OCC, the Reporting Team and the Investigation Team.[591] Fannie Mae is in the process of updating the manner in which information regarding possible mortgage fraud flows, as it continues to make changes to its fraud reporting procedures.[592]

Fannie Mae reported to OFHEO ten suspected incidents of mortgage fraud in September 2005 (which was the first report and covered historic investigations); one in November 2005; one in December 2005; and one in January 2006.[593] Since the reporting rule did not become effective until the end of August 2005, the Third Quarter Report on MFINs only includes the ten cases Fannie Mae reported in September 2005. Of those, the number of loans thought to be involved in the suspected fraud ranged from ten to 771, and the estimated unpaid

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[588] Miriam Smolen currently fills this position.

[589] National Underwriting Center (NUC) Fraud Team Procedures for Reporting Mortgage Fraud and Possible Mortgage Fraud to OFHEO.

[590] *Id. See also* Business Process Model, Flowchart 3.1 – Single-Family – Submission of MFIN Form to OFHEO Process.

[591] National Underwriting Center (NUC) Fraud Team Procedures for Reporting Mortgage Fraud and Possible Mortgage Fraud to OFHEO. *See also* Business Process Model, Flowchart 3.1 – Single-Family – Submission of MFIN Form to OFHEO Process.

[592] Telephone interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 28, 2006).

[593] *Id.*

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principal balance ("UPB") ranged from $356,600 to nearly $113 million.[594] Seven cases involved appraisal issues, six involved borrower issues, and one involved institutional fraud issues.[595] The investigation involving institutional fraud was closed, with no fraud found.

In addition to reporting mortgage fraud or possible mortgage fraud, the OFHEO regulation also requires Fannie Mae to establish certain internal controls and procedures and a training program. In April 2005, Fannie Mae created the position of Vice President of Anti-Fraud Initiatives to fill the role of mortgage fraud officer, as required under OFHEO's regulation.[596] As for OFHEO's requirements regarding a central reporting point and repository for mortgage fraud, Fannie Mae has e-mailboxes for both Fannie Mae employees and external parties to report possible mortgage fraud.[597] Fannie Mae also receives tips from consumers through the Consumer Resource Center ("CRC").[598] When the CRC receives a telephone call alleging fraud, it collects as much information as possible and records it on a Report of Suspected Mortgage Fraud, which it submits to the Anti-Fraud Team.[599] The CRC then transfers the call to the Anti-Fraud Team for further data collection.[600] The Anti-Fraud Team maintains all mortgage fraud tips and cases.[601] The tips and cases are currently maintained in an end-user managed application, but this will transition into a centrally managed application this year.[602]

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[594] Fannie Mae Quarterly Status Report of Mortgage Fraud Incident Notices, 3rd Quarter of 2005, 7/1/2005 Through 9/30/2005.

[595] *Id.*

[596] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule.

[597] *Id.* All Fannie Mae staff has access via the intranet to the central e-mailbox, MortgageFraud_Tips@fanniemae.com, and external parties have access to the e-mailbox via www.FannieMae.com and www.eFannieMae.com.

[598] Single-Family Anti-Fraud Protocols and Procedures, p. 6.

[599] *Id.*

[600] *Id.*

[601] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule.

[602] *Id.*

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As for the requirement that Fannie Mae designate mortgage fraud or senior management officers to approve any continued business with an entity suspected of mortgage fraud, Fannie Mae's Single Family credit delegation is a function that defines who is responsible for approving or terminating sellers and servicers and the management processes for making those decisions.[603]

OFHEO also requires Fannie Mae to publish its mortgage fraud reporting procedures and anti-fraud policies internally. The corporate Anti-Fraud Policy and the Protocols and Procedures are available to all Fannie Mae staff on Fannie Mae's intranet.[604]

Turning to the next OFHEO rule requirement, Fannie Mae must publish information on who external parties should contact to report mortgage fraud notices or tips. Fannie's websites, www.FannieMae.com and www.eFannieMae.com, instruct individuals to report suspected mortgage fraud to a toll free number (for the CRC) or to the central e-mailbox, as described above.[605] Finally, as for training, Fannie Mae has conducted a training program in the Single Family division on preventing and detecting mortgage fraud, and plans to conduct a corporate version this year.[606]

D. Lessons from the First Beneficial Case

The discovery of a fraud committed by First Beneficial Mortgage Corp. ("First Beneficial"), based in North Carolina, demonstrates that Fannie Mae's practice of not informing victims of mortgage fraud creates a risk of liability. In 2004, Fannie Mae entered into a Consent

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[603] *Id.*

[604] *Id.*; E-mail from Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business, to Ambika Biggs (Feb. 28, 2005).

[605] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule. *See also* http://www.fanniemae.com/contact/ and http://www.efanniemae.com/utility/legal/antifraud.jsp.

[606] Fannie Mae Response to OFHEO Mortgage Fraud Reporting Rule.

Order in which it forfeited $7.5 million to the United States because it received funds that another company had obtained by fraud.[607] First Beneficial defrauded Fannie Mae by selling it fraudulent loans.[608] When Fannie Mae discovered the loans were fraudulent, it demanded First Beneficial repurchase the loans.[609] In order to obtain the funds to repurchase the mortgages, First Beneficial defrauded Ginnie Mae by using the same scheme that it had used on Fannie Mae.[610] Ginnie Mae suffered more than $23 million in damages as a result of the fraud.[611]

The Justice Department conducted an investigation of Fannie Mae on behalf of Ginnie Mae.[612] In the Consent Order, Fannie Mae agreed that the funds were forfeitable under applicable laws and stated that it did not "wish to retain those funds or benefit from the receipt of such funds."[613] It forfeited the funds, which were $6,522,188.08, plus $978,328.00 in interest, to the United States.[614] It had standing to file a claim or petition under 21 U.S.C. § 853(n) for the return of the funds under the Preliminary Order of Forfeiture,[615] and to request a hearing to determine if it received the funds without knowledge of their fraudulent origin, but it waived that right in the Consent Order.[616] The Consent Order explicitly stated that Fannie Mae was a victim

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[607] Press Release, Department of Justice, Dec. 8, 2004.

[608] *U.S. v. McLean*, 131 Fed. App'x. 34, 36 (4th Cir. 2005). First Beneficial's owners, James and Macy McLean, as well as other First Beneficial employees, recruited individuals to sign mortgage loan notes to secure funds for homes that either did not exist or that were owned by someone other than the borrower named on the note. These fraudulent notes were then sold to Fannie Mae. The McLean's were convicted of various federal offenses in a separate criminal case. The section on accounting and securities fraud addresses Fannie Mae's procedures for ensuring that promissory notes that it purchases are adequately backed by houses.

[609] *Id.* at 37.

[610] *Id.*

[611] Press Release, Department of Justice, Dec. 8, 2004.

[612] *Id.*

[613] *U.S. v. McLean*, Consent Order of Forfeiture, ¶ 6, , No. 3:02CR156-T (W.D.N.C., Dec. 8, 2004).

[614] *Id.* at ¶ 8.

[615] *Id.* at ¶ 10.

[616] Press Release, Department of Justice, (Dec. 8, 2004).

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of a mortgage fraud scheme perpetrated by First Beneficial,[617] and that the order did not "constitute or [should not] be construed as an admission by Fannie Mae of guilt of, violation of, or noncompliance with, any federal, state or local law, statute, regulation, or public policy."[618]

Although Fannie Mae was ordered to forfeit the funds because they were the product of fraud, and not because Fannie Mae failed to warn Ginnie Mae of First Beneficial's mortgage fraud scheme, the Justice Department and members of Congress focused on the fact that Fannie Mae did not disclose the fraud after discovering it, enabling First Beneficial to resell the fraudulent loans to Ginnie Mae.[619] During the criminal trial of the owners of First Beneficial, investigators discovered that Fannie Mae did not notify regulators of the fraud.[620]

Representatives Richard Baker, R-La., Sue Kelly, R-N.Y., and Robert Ney, R-Ohio, wrote a letter to then Fannie Mae Chief Executive Franklin Raines stating that they were "very concerned that the U.S. taxpayers may have been put at risk when certain loans were sold by First Beneficial Mortgage to Ginnie Mae after many of the same loans were determined to be fraudulent by the executives at Fannie Mae."[621] They asked whether Fannie Mae sought to inform OFHEO, HUD, Ginnie Mae or the Department of Justice that First Beneficial was attempting to sell fraudulent loans, and whether Fannie Mae notifies state and federal authorities when it discovers a lender has sold it fraudulent loans.[622] They also questioned whether Fannie

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[617] *U.S. v. McLean*, Consent Order of Forfeiture, ¶ 3, No. 3:02CR156-T (W.D.N.C., Dec. 8, 2004).

[618] *Id.* at ¶ 15.

[619] Dawn Kopecki, "Fannie Seeks to Settle Federal Mtge Fraud Case – Sources,' Dow Jones News Service, December 3, 2004.

[620] *Id.*

[621] *Id.; see also* Letter from Reps. Richard Baker, R-La., Sue Kelly, R-N.Y., and Robert Ney, R-Ohio to Mr. Raines (Dec. 1, 2004).

[622] Letter from Reps. Richard Baker, R-La., Sue Kelly, R-N.Y., and Robert Ney, R-Ohio (Dec. 1, 2004).

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Mae discloses the fact that it has suspended a lender, which would put others on notice that the lender may have engaged in criminal activity.[623]

OFHEO's fraud regulation was issued, in part, in response to the *First Beneficial* case.[624] The regulation, however, still does not require Fannie Mae or anyone else to inform the borrowers, who may be victims, of the fraud.

E. The Olympia Fraud Response Model

In at least one case in which Fannie Mae discovered a lender fraud, it took measures to ensure that borrowers were informed and any harm corrected. In the fall of 2004, Fannie Mae discovered that Olympia Mortgage Corporation ("Olympia") had defrauded borrowers who refinanced their mortgages. Olympia sold mortgages to Fannie Mae, and Fannie Mae remitted the purchase price to Olympia for payment of the mortgages.[625] Olympia was supposed to use the funds to pay off the borrowers' mortgage notes, but it failed to do so.[626] As a result, the borrowers had two mortgages on their property, instead of the one refinanced mortgage.[627] The fraud involved about 240 loans that were worth about $40 million in total.[628]

When Fannie Mae discovered the fraud, it transferred the mortgages from Olympia to Cenlar, a subservicer that Fannie Mae entrusted with the responsibility of correcting the damage to borrowers.[629] Cenlar reviewed each loan that was involved in Olympia's fraud and

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[623] *Id.*

[624] *See* OFHEO New Release, OFHEO Proposes Regulation to Require Fannie Mae and Freddie Mac to Report Mortgage Fraud, (Feb. 22, 2005). The news release states that the proposed rule cited First Beneficial, Olympia, and United Homes LLC as recent examples of fraud or alleged fraud.

[625] Interview with Bill Brewster, Director of Anti-Fraud Initiatives (Nov. 7, 2005).

[626] *Id.*

[627] *Id.*

[628] Interview with John Gang, Vice President, Asset Acquisitions and Custody (Dec. 8, 2005).

[629] Interview with Mercy Jimenez, Senior Vice President of the National Business Center (Nov. 7, 2005).

corrected any problems resulting from the fraud.[630] Cenlar also worked with borrowers and credit ratings agencies to remove inaccurate information from borrowers' credit records.[631] In late 2004, Fannie Mae issued a press release to inform investors that Fannie Mae had purchased the loans out of the pool, so there would be a quick pay down on the loans instead of a stream of monthly payments on them.[632] The press release informed investors that Fannie Mae had forced the lender to repurchase the loans, but it did not say it was due to fraud.[633]

F. Findings Regarding Fraud Procedures

In the area of fraud reporting, Fannie Mae has implemented procedures to comply with OFHEO reporting requirements. In the view of Fannie Mae executives, predatory practices are prevalent in the subprime market in which Fannie Mae participates to only a limited extent. Of Fannie Mae's 1,500 active servicers, only 33 are non-traditional servicers, and not even all of those are subprime servicers.[634] Mr. Lavalle's target subprime servicers – EMC Mortgage, Litton Loan Servicing, Ocwen, and SPS – were primary servicers for less than one percent of Fannie Mae's loans from 2002 to 2004.[635] Fannie Mae's enforcement of servicer requirements has placed a greater emphasis in recent years on identifying and correcting predatory lending and servicing issues and detecting fraud. Fannie Mae has created the position of Vice President for Anti-Fraud Initiatives which gives these enforcement efforts visibility within the company. Fannie Mae also is using an extensive computer analysis of its portfolio to detect anomalies

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[630] *Id.*

[631] *Id.*

[632] Interview with John Gang, Vice President, Asset Acquisitions and Custody (Dec. 8, 2005).

[633] *Id.*

[634] Telephone Interview with Rick Bauerband, Director of Non-Traditional Servicing (Mar. 14, 2006); E-mail attachment of a chart of the Servicer Counts for Year-Ends 2002-2004, from Marianne Sullivan, Senior Vice President, Credit Loss Management (Mar. 1, 2006).

[635] All Active Single-Family Loans chart from Marianne Sullivan, Senior Vice President, Credit Loss Management.

which are then investigated.[636] These analyses are now being specifically used for enforcement purposes. To date, the level of fraud detected has been relatively minor, only 13 incidents reported from September 2005 through January 2006, most of which occurred before September 2005.[637]

VII.
ACCOUNTING AND SECURITIES FRAUD

A. Fannie Mae's Financial Investigations and Reviews

Fannie Mae is in the process of extensively reviewing and restating its financial results from previous years. In November 2003, OFHEO began a special examination of Fannie Mae's accounting practices and policies.[638] Although it has not completed its review, OFHEO reported its findings to date on September 17, 2004, because they raised serious issues that warranted immediate attention.[639] Fannie Mae's Board agreed to take immediate action to address the issues raised in the report.[640] In February 2005, Fannie Mae announced that OFHEO had notified it of additional accounting and internal controls issues that OFHEO had identified.[641] On March 7, 2005, Fannie Mae and OFHEO entered into a supplement to address

[636] Telephone interview with Steve Holden, Director of Loan Portfolio Risk (Jan. 28, 2006); Interview of Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005).

[637] Fannie Mae Quarterly Status Report of Mortgage Fraud Incident Notices, 3rd Quarter of 2005, 7/1/2005 Through 9/30/2005; Interview with Peter Kopperman, Vice President, Anti-Fraud Initiatives, Single-Family Mortgage Business (Feb. 28, 2006).

[638] Executive Summary, A Report to the Special Review Committee of the Board of Directors of Fannie Mae, Paul, Weiss, Rifkind, Wharton & Garrison LLP ("Rudman Report").

[639] Report of Findings to Date, Special Examination of Fannie Mae, Office of Compliance, Office of Federal Housing Enterprise Oversight, September 17, 2004 [hereinafter "the OFHEO Report"].

[640] News Release, Fannie Mae, Fannie Mae Directors Agree to Correct Accounting Treatments, Raise Capital Surplus as Required by OFHEO (Sept. 27, 2004).

[641] U.S. Securities and Exchange Commission Form 12b-25, for period ended December 31, 2004.

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the newly discovered concerns.[642] OFHEO has yet to issue its final report on its special examination of Fannie Mae.[643]

After OFHEO made its September 2004 report, Fannie Mae requested that the SEC's Office of the Chief Accountant review how Fannie Mae applied Financial Accounting Standard ("FAS") No. 91 and FAS 133, which deal with deferred price adjustments, and derivatives and hedging activities, respectively.[644] The SEC reviewed Fannie Mae's accounting practices for 2001 through mid-2004 and found that Fannie Mae had not complied with the accounting requirements for FAS 91 and FAS 133.[645] The SEC advised Fannie Mae to restate the financial statements it had filed with the SEC. Fannie Mae has stated that the interim and audited reports and the independent auditor's reports that it filed for that period should not be relied upon.[646] It is in the process of restating its financial statements.[647]

Also in September 2004, the Board's Special Review Committee asked U.S. Senator Warren Rudman and the law firm Paul, Weiss, Rifkin, Wharton & Garrison, LLP, ("Paul, Weiss") to conduct an extensive review of the issues raised in the OFHEO report, as well as others issues relating to accounting, governance, internal controls and structure.[648] The Board released the report ("Rudman Report") on the investigation on February 23, 2006.[649]

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[642] *Id.*

[643] News Release, Fannie Mae, Statement by Stephen B. Ashley, Chairman of the Board of Directors (Feb. 23, 2006).

[644] U.S. Securities and Exchange Commission Form 12b-25, for period ended December 31, 2004.

[645] Press Release, U.S. Securities and Exchange Commission, Office of the Chief Accountant Issues Statement on Fannie Mae Accounting (Dec. 15, 2004), available at http://www.sec.gov/news/press/2004-172.htm.

[646] U.S. Securities and Exchange Commission Form 12b-25, for period ended December 31, 2004.

[647] U.S. Securities and Exchange Commission Form 12b-25, for period ended December 31, 2004.

[648] News Release, Statement by Stephen B. Ashley, Chairman of the Board of Directors (Feb. 23, 2006).

[649] *Id.*; *see also* Executive Summary, A Report to the Special Review Committee of the Board of Directors of Fannie Mae, Paul, Weiss, Rifkind, Wharton & Garrison LLP [hereinafter "the Rudman Report"].

In light of these investigations, we have limited our review of Mr. Lavalle's assertions to determining whether his issues are addressed through tests and analyses designed to ensure the accuracy of financial reporting or are under review in the current review of accounting controls and restatement of financial statements.

B. Mr. Lavalle's Accounting and Securities Concerns

Mr. Lavalle has accused Fannie Mae of engaging in accounting and securities fraud arising from the other issues he raises. He has specifically focused on the following four areas: (1) impact of servicer frauds on Fannie Mae's financial statements; (2) the alleged failure to remove paid-off promissory notes from MBS pools; (3) the question of whether terms of MBS's comply with true sale accounting rules; and (4) whether the transfer of holder status to servicers during foreclosure proceedings are accounted for properly.

1. Impact of Servicer Frauds

Mr. Lavalle claims that the fraudulent practices of servicers distort Fannie Mae's financial statements. When mortgage servicing abuses are discovered, each mortgage needs to be reamortized and recalculated to reflect the correct principal balances and loan-to-value ratios ("LTVs"), Mr. Lavalle asserts.[650] He questions whether these recalculations are being done.[651] Mr. Lavalle alleges that when servicers engage in predatory servicing, they are employing a number of financial engineering schemes designed to boost their profits. These schemes have a direct effect on the income cash flow, mortgage servicing right ("MSR") values, LTVs, principal and interest, asset values, principal values, amortization of balances, servicing fees and net

[650] E-mail dated Oct. 7, 2005, from Nye Lavalle to Mark Cymrot.

[651] *Id.*

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liquidation proceeds.[652] These schemes affect what servicers, investors, Fannie Mae and MBS trusts report, he claims.[653]

Mr. Lavalle complains about the following fraudulent schemes: misapplication of payments via delayed application to principal, application to suspense/unapplied accounts, escrow overpayments, failure to timely credit prepayments and payments, and payments to non-recoverable fees instead of principal and interest; force-placed insurance schemes; escrow account schemes; and fee schemes.[654] "[O]nce an error or manipulated engineering scheme occurs, every transaction from that date forward is affected," Mr. Lavalle asserts.[655] The amount the borrower pays, the amount of the payment that is applied towards principal, the amount of interest that accrues, and the late fees charged are affected by the scheme, he claims.[656] This impact is especially true for negative amortization and ARM loans when the amount that is applied to principal and interest is calculated using the current monthly principal balance, he claims.[657] These faulty numbers in turn affect reports to investors and rating agencies, and SEC filings, he alleges.[658] In order to fix these errors, the loans must be audited manually to correct each point of error, he asserts.[659]

Mr. Lavalle asserts that if the errors are truly mistakes, and not the result of financial engineering schemes, about 50 percent of the errors should be over-charges and about

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[652] Nye Lavalle, report on his allegations against Fannie Mae (Feb. 2, 2006) (unpublished report), sent as attachment to e-mail dated Feb. 2, 2006 10:25 EST to Mark Cymrot.

[653] *Id.*

[654] *Id.*

[655] *Id.*

[656] *Id.*

[657] *Id.*

[658] *Id.*

[659] *Id.*

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50 percent should be under-charges.[660] If the overcharges constitute more than 60 percent of the errors, and especially if they constitute between 80 to 99.9 percent of the errors, that is proof of financial engineering schemes, he claims.[661] In order to determine what percentage of errors are beneficial or detrimental to borrowers, Fannie Mae would need to conduct ARM, payoff figure, servicing and escrow audits on a pool of loans either by auditing each loan or taking a random sample of the pool, he asserts.[662]

Mr. Lavalle estimates that Fannie Mae has miscalculated the amount of principal balance claims due and owing on ARM loans, Alt A, B and C paper and negative amortization loans by 10 to 25 percent.[663] He projects a 2.5 to 5 percent miscalculation of principal balances due and owing for standard A paper loans with traditional fixed 15- and 30-year terms.[664] He claims that he bases his estimates on discussions with servicers and mortgage audit firms, and his research of auditing, quality assurance and due diligence firms, reports and websites.[665]

Mr. Lavalle alleges that when the mortgage servicers report inaccurate financial information, Fannie Mae's financial statements become distorted. Inaccurate principal balances also may cause Fannie Mae to overpay servicing fees, he claims, because servicing fees are typically calculated based on outstanding principal balances.[666] In addition, Mr. Lavalle alleges that Fannie Mae uses this inaccurate financial information provided by its servicers in its filings with the Securities and Exchange Commission ("SEC") and in its prospectus, so the

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[660] *Id.*

[661] *Id.*

[662] *Id.*

[663] *Id.*

[664] *Id.*

[665] *Id.*

[666] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

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characteristics of loan pools are inflated over their true values.[667] Thus, investors receive information that is false, in violation of state and federal securities laws, RICO and Deceptive Trade Practices laws, Mr. Lavalle claims.[668]

2. Promissory Notes in MBS Pools

Mr. Lavalle raises issues regarding promissory notes in MBS pools. He questions what processes are in place for taking paid off promissory notes out of MBS pools.[669] Mr. Lavalle claims to have been informed by mortgage industry executives that paid off promissory notes are still part of securitized pools.[670] He has not provided any documentary evidence of these statements. Mr. Lavalle alleges that fraudulent duplicate promissory notes are being sold, traded, and placed in securitized pools.[671] Thus, in some cases two promissory notes are being sold for the same debt and one property serves as collateral.

He asserts that Fannie Mae has transformed promissory notes into "fiat money" because they are not backed by a fixed asset.[672] He fears Fannie Mae is claiming that the securities it issues are backed by mortgages when in fact they are not.[673]

3. True Sale Opinions

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[667] *Id.*

[668] *Id.*

[669] Telephone Interview with Nye Lavalle (Nov. 1, 2005).

[670] *Id.* In support of his allegations, Mr. Lavalle refers generally to Margery A. Colloff, "The Role of the Trustee in Mitigating Fraud in Structured Financings," J. of Structured Finance (Winter 2005). The article states "Government-reimbursed programs are at the top of the list [of hot spots for fraud]" because "[c]ollateral may be overvalued, or non-existent, or pledged to more than one transaction. No one knows because the collateral is often in the custody of the servicer or another business party, not the trustee." *Id.* at 3.

[671] Telephone Interview with Mr. Lavalle (Nov. 1, 2005). *See* E-mail dated Nov. 30, 2005, with attachments from Carl Erickson, which include an allegedly fraudulent promissory note. Mr. Erickson claims that two different companies – Freddie Mac and the Charles F. Curry Company – claimed to be the owner of the note at the same time. Mr. Erickson has communicated with Mr. Lavalle, as is evidenced in the e-mail.

[672] Telephone Interview with Nye Lavalle (Nov. 23, 2005).

[673] Telephone Interview with Nye Lavalle (Nov. 1, 2005) *See also* e-mail from Mr. Lavalle to Ms. House (Jan. 8, 2004).

Mr. Lavalle questions how Fannie Mae and Freddie Mac are dealing with the issue of "true sales" in securitization transactions. He claims that the majority of securitization transactions is not true sales, but instead is the financing of receivables that should be accounted for on the balance sheet.[674] He asserts that some of these sales may not be true sales because the transactions contain recourse provisions that require the lender to repurchase the loan from the pool or replace it if there is a problem with the loan.[675] He also claims that Fannie Mae has "side and verbal implicit and moral recourse agreements with many ... parties and counter-parties to various securitization transactions."[676]

Mr. Lavalle has asked, "Once in a SPV/SPE or QSPE trust, what time period can a note that has gone 'into trust' be allowed to come out for a discovered fraud, problem, foreclosure or default? ... If after a certain time period, doesn't this practice constitute a violation of the 'true sale' provisions and mandate that such assets and liabilities be carried on balance sheet? Doesn't this destroy the 'trust' and 'remote bankruptcy' treatments?"[677]

4. Impact of Holder Status During Foreclosures

Fannie Mae's foreclosure practices could have an effect on its financial statements, Mr. Lavalle claims. Fannie Mae's foreclosure guidelines transfer holder status from Fannie Mae to the servicer at the time of foreclosure. Mr. Lavalle questions whether the loans should come off Fannie Mae's books at that point.

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[674] Telephone interview with Nye Lavalle (Nov. 1, 2005); E-mail dated Dec. 19, 2003, from Nye Lavalle to then-Fannie Mae Chairman and Chief Executive Officer Franklin Raines and other Fannie Mae employees, as well as other individuals.

[675] Telephone interview with Nye Lavalle (Nov. 1, 2005).

[676] E-mail dated July 22, 2005, from Nye Lavalle to Mr. Mudd, Ms. House, and various members of Fannie Mae's Board of Directors.

[677] Nye Lavalle, report on his allegations against Fannie (Feb. 2, 2006) (unpublished report), sent as attachment to e-mail dated Feb. 2, 2006, to Mark Cymrot.

C. Servicer Reports of Financial Transactions

Mr. Lavalle's claims regarding servicer fraud are essentially an attack on the integrity of Fannie Mae's financial reporting. Fannie Mae has the LASER computer system through which servicers report transactions regarding mortgages. Fannie Mae's Loan Portfolio Risk unit conducts numerous statistical analyses of servicer portfolios to ensure they perform as expected.[678] One area specifically reviewed is quality control; that is an analysis of how accurate a lender's reports are.[679] Anomalies are investigated and further analysis or corrective action is undertaken through the appropriate business unit.[680] The lender reporting system is also subject to internal and external audits, including the current investigations by OFHEO and Fannie Mae's auditors. It, thus, appears that Fannie Mae's accounting system addresses Mr. Lavalle's concerns about servicer reporting. In light of the pending external reviews, we have not undertaken a review of Mr. Lavalle's specific concerns.

D. Under-Collateralization of MBS Pools

1. Paid Off Promissory Notes

Fannie Mae also has a variety of computer systems for lenders and servicers to report MBS information, including the LASER and MAST systems.[681] The LASER system is for loan level reporting, while the MAST system is for pool level reporting.[682] Fannie Mae calculates its own expectations for this data based upon its past experiences.[683] Anomalies from the usual results are identified and Fannie Mae works with servicers to determine the reasons for

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[678] Interview with Steve Holden, Director, Loan Risk Portfolio (Jan. 27, 2006).

[679] *Id.*

[680] *Id.*

[681] Interview of Dror Oppenheimer, Vice President, Asset Development and Management (Dec. 7, 2005).

[682] *Id.*

[683] *Id.*

the variations and resolve any issues that may arise.[684] In addition, Fannie Mae's Custodian Unit and the private certified custodians conduct physical checks of information contained on the mortgage documents when they arrive.[685] Fannie Mae also conducts post-purchase quality control and reviews. The pay down schedules are reconciled to the actual cash received to ensure that pay offs and other transactions are being properly accounted for.[686] After the *Olympia* fraud, Fannie Mae built additional functions into its system to check for duplicate loans and pay offs.

2. Duplicate Loans for Same Property

Fannie Mae has procedures in place to prevent it from purchasing fraudulent duplicate loans. In the wake of discovering *Olympia* fraud, Fannie Mae implemented a process to check for duplicate loans.[687] Fannie Mae's credit analytics produce a monthly report listing all instances in which the same address is listed for more than one loan and then they investigate the discrepancy.[688] In the majority of the cases in which the same address is listed for multiple loans, the property has multiple units (i.e., condominiums), and the unit numbers were not recorded.[689] Fannie Mae now uses information provided by the United States Postal Service to determine whether an address that is listed for more than one loan belongs to a multi-unit property.[690] Fannie Mae has had a few minor incidents, but has not found any systematic

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[684] *Id.*

[685] Interview of Debra Thompson, Director, Asset Acquisitions and Custody (Nov. 8, 2005).

[686] Interview of Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005).

[687] Interview with Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005).

[688] *Id.*

[689] *Id.*

[690] *Id.*

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fraud.[691] In those cases in which duplicate loans have been found, NSO's quality control unit determines how the issue should be resolved and whether the seller must repurchase the loan.[692]

3. Inflated Property Appraisals

Fannie Mae also has procedures in place to protect itself against appraisal fraud. When Fannie Mae purchases a loan, the lender reports the mortgaged property's address, appraised value, and sales price.[693] Employees in Fannie Mae's loan portfolio risk team compare the appraised value to the value on Fannie Mae's automated valuation model ("AVM").[694] Fannie Mae does not have the value for every mortgaged property, but it can estimate values if it has the tax assessment, the number of rooms and square footage of the property, or if it has dealt with the loan previously.[695]

If there is a large discrepancy between the appraised value and the value on the AVM, the loan portfolio risk team flags the discrepancy for the underwriters to review.[696] Oftentimes the flag is due to a model error. For instance, the homeowner may have renovated the house, increasing its value, but Fannie Mae may be unaware of the renovation.[697] If Fannie Mae does discover appraisal fraud, the lender must repurchase the loan.[698]

With respect to MBS financial reporting, Fannie Mae's accounting system has systems to ensure loans backing MBS are properly accounted for. In light of the pending external reviews, we have not undertaken additional efforts to test these systems.

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[691] *Id.*

[692] *Id.*

[693] Telephone interview with Steve Holden, Director of Loan Portfolio Risk (Jan. 28, 2006).

[694] *Id.*

[695] *Id.*

[696] *Id.*

[697] *Id.*

[698] *Id.*

E. True Sale Opinions

Mr. Lavalle has questioned whether Fannie Mae's policy of removing certain loans from MBS trusts negates the "true sale" qualities of a transaction.[699] As previously explained, Fannie Mae can require lenders to repurchase mortgages for a variety of reasons, such as violations of a selling warranty, improper servicing that has adversely affected the value of portfolio mortgages, ARMs in MBS pools have been converted to fixed-rate mortgages, or MBS pool mortgages have 24 payments past due.[700] Instead of requiring the lender to repurchase a delinquent special servicing option MBS pool mortgage, Fannie Mae also can automatically reclassify the mortgage as a portfolio mortgage.[701]

Mr. Lavalle asserts that recourse provisions requiring or allowing lenders to repurchase loans or take loans out of an MBS pool may mean that the initial sales transaction was not a "true sale" and should not be accounted for as such.[702]

For tax and accounting purposes, when lenders sell whole mortgages to Fannie Mae, those loans are recorded on Fannie Mae's balance sheet as assets.[703] When a lender sells loans to Fannie Mae to be securitized, the loans are not recorded on Fannie Mae's balance sheet because they are not Fannie Mae's assets.[704] Rather, a trust is established under the trust

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[699] Nye Lavalle, report on his allegations against Fannie Mae (Feb. 2, 2006) (unpublished report), sent as attachment to e-mail to Mark Cymrot (Feb. 2, 2006 10:25 EST).

[700] Selling Guide, I-208.

[701] *Id.*

[702] E-mail dated Dec. 19, 2003, from Nye Lavalle to Frank Raines and others.

[703] Interview with Kirk Silva, Vice President in Accounting Policy (Nov. 23, 2005); Interview with Greg Williams, Director of Finance (Nov. 8, 2005).

[704] Mortgage Backed Securities: Basics of Fannie Mae MBS: Basics of MBS Market & Pools, available at http://www.fanniemae.com/mbs/mbsbasics/market. *See also* U.S. Securities and Exchange Commission, Form 10-K, Annual Report for fiscal year ended December 31, 2003, p. 90 (Fannie has since determined that "its previously filed interim and audited financial statements for the periods from January 2001 through the second quarter of 2004 must be restated and should no longer be relied upon.").

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indenture and the assets are placed in that trust.[705] Fannie Mae "holds the mortgage loans, in [its] capacity as trustee under the trust indenture, for the benefit of all the holders of certificates of the same issue."[706] Fannie Mae issues certificates that represent a fractional undivided beneficial ownership interest in the pool of loans.[707] "Each beneficial owner of a certificate will be considered to be the beneficial owner of a pro rata undivided interest in each of the mortgage loans included in that particular pool" and "must report on its federal income tax return its pro rata share of the entire income from each mortgage loan in that particular pool, consistent with the beneficial owner's method of accounting."[708]

The only circumstance in which a loan in a pool for securitization would be recorded on Fannie Mae's accounting books is if the loan becomes delinquent and Fannie Mae purchases it out of the pool.[709] In all other cases, the trust holds the assets.[710]

In order for Fannie Mae to keep an MBS trust's assets off-balance sheet, the trust must meet certain criteria that establish it as a Qualified Special Purpose Entity ("QSPE").[711] Under Financial Accounting Standard ("FAS") No. 140, the trust must be beyond the reach of the entity to qualify as a QSPE. If the trust does not meet the requirement for a QSPE, FASB Interpretation ("FIN") No. 46 requires the party that stands to gain or lose the most from a

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[705] Interview with Kirk Silva, Vice President in Accounting Policy (Nov. 23, 2005). *See also* Single-Family MBS Prospectus, January 1, 2006, p. 18.

[706] Single-Family MBS Prospectus, January 1, 2006, p. 18.

[707] *Id.* at 18.

[708] *Id.* at 45, 46.

[709] Interview with Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005). In some cases, Fannie Mae purchases the loan from the pool if the borrower is four months delinquent. In other cases, Fannie Mae does not purchase the loan until the point of foreclosure. *See also* Interview with Greg Williams, Director of Finance (Nov. 8, 2005). Sometimes when the trust creates MBS, Fannie purchases the MBS. In those cases, the MBS that are reflected on Fannie Mae's accounting books are investments.

[710] Interview with Kirk Silva, Vice President in Accounting Policy (Nov. 23, 2005). There is *not* a separate accounting book for the trust.

[711] *Id.*

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Special Purpose Entity ("SPE") whose ownership is otherwise unclear to consolidate the SPE's financial data in its own statements.[712]

The Rudman Report addresses situations in which Fannie Mae invests in MBS that it guarantees. From time to time, Fannie Mae acquires interest in MBS, and at times, it has acquired 100 percent of the MBS from certain trusts.[713] When FIN 46 was adopted in 2003, Fannie Mae had to determine whether those trusts should be consolidated into its balance sheet.[714] It created Megas, trusts into which it transferred wholly-owned MBS trusts, and then sold one percent of the beneficial interest in each Mega to a third party.[715] Fannie Mae believed this would enable it to avoid consolidating the trusts onto its balance sheets because it would no longer have the unilateral ability to dissolve the trusts.[716] This approach proved to be incorrect, and management is now reviewing these transactions as part of its restatement effort.[717]

With respect to other aspects of the true sale issue, Fannie Mae did not obtain independent true sale opinions prior to its current financial restatement.[718] Fannie Mae is in the process of reviewing transactions to determine whether they constitute true sales and has retained two law firms to provide legal opinions on the issue.[719] We, therefore, have not addressed this issue further.

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[712] Tim Reason, "FIN 46 and Balance-Sheet Consolidation," CFO Magazine, September 24, 2004.

[713] Rudman Report, p. 16.

[714] *Id.*

[715] *Id.*

[716] *Id.*

[717] *Id.* at 16-17.

[718] Interview with Kirk Silva, Vice President in Accounting Policy (Nov. 23, 2005).

[719] *Id.*

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F. Accounting for Holder Status in Foreclosure

Mr. Lavalle has questioned on whose accounting books promissory notes are recorded in cases in which servicers or MERS claim to be the holder and owner of the notes during foreclosure actions.[720] Fannie Mae's Servicing Guide makes it clear that Fannie Mae is at all times the owner of the note.[721] The mortgage, thus, is accounted for in Fannie Mae's accounting books.[722] Holder status can change during the life of a mortgage, even when Fannie Mae or a Fannie Mae trust is the owner. Even in these instances, the asset remains on Fannie Mae's (or the trust's) balance sheet, and not the servicer's.[723]

An individual can be the holder of a promissory note without being the owner of the note. The U.C.C., which determines whether an entity is a holder or not, does not address ownership of negotiable instruments.[724] The U.C.C. states that the "right to enforce an instrument and ownership of the instrument are two different concepts."[725] Thus, when Fannie Mae transfers the holder status to servicers, Fannie Mae continues to account for the mortgage on its accounting books because it remains the owner.[726]

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[720] Telephone Interview with Nye Lavalle (Feb. 6, 2006).

[721] Servicing Guide, VIII-102. This section of the Guide is on the initiation of foreclosure proceedings. It states: "Fannie Mae is at all times the owner of the mortgage note, whether the note is in our portfolio or whether we own it as trustee for an MBS trust."

[722] Interview with Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005); Telephone Interview with Robin Gillespie, Vice President and Deputy General Counsel. (Mar. 16, 2006).

[723] Telephone Interview with Kirk Diehl, Senior Manager in Accounting Policy (Mar. 22, 2006); Interview with Dror Oppenheimer, Vice President for Asset Development and Management (Dec. 7, 2005).

[724] U.C.C. Revised Article 3-203, Official Comment states: "Ownership rights in instruments may be determined by principles of the law of property, independent of Article 3, which do not depend upon whether the instrument was transferred under Section 2-302."

[725] U.C.C. Revised Article 3-203, Official Comment.

[726] Telephone Interview with Kirk Diehl, Senior Manager in Accounting Policy (Mar. 22, 2006); Telephone Interview with Robin Gillespie, Vice President and Deputy General Counsel. (Mar. 16, 2006).

G. Findings Regarding Accounting and Securities Fraud

Since Fannie Mae's accounting system is undergoing extensive external review from OFHEO and independent accountants and lawyers, we have not undertaken a separate review of Mr. Lavalle's assertions regarding Fannie Mae's financial statements. The issues raised by Mr. Lavalle are addressed in the accounting system, and any issues regarding these issues should be resolved as a result of the current reviews.

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