OFFICE OF INSPECTOR GENERAL

Federal Housing Finance Agency

400 7th Street, S.W., Washington DC 20024

August 21, 2014

For: Melvin L. Watt, Director

From: Michael P. Stephens, Acting Inspector General

Subject: Systemic Implication Report: TBW-Colonial Investigation Lessons Learned
SIR No.: SIR-2014-0013
OIG Case No.: I-11-0010

Attached is a paper that is intended to extract lessons learned from a multifaceted and multiyear fraud scheme perpetrated by officers and employees of Taylor, Bean & Whitaker Mortgage Corporation (TBW) and Colonial Bank (Colonial), which — in its June 2011 SEC Form 8K — Freddie Mac stated caused it to file a \$1.78 billion proof of claim in TBW's bankruptcy, as a result of pending and projected repurchase obligations, funds deposited with Colonial related to Freddie Mac-owned or –guaranteed loans, and miscellaneous expenses. These lessons learned derive from evidence compiled during the investigation of TBW's and Colonial's fraud scheme.

The paper reports that various red flags should have alerted counterparties, investors, and regulators to the fraud scheme, but they were not adequately addressed. The failure to adequately address the red flags cost various parties losses of billions of dollars. To avoid a recurrence of such losses, the Enterprises need to improve counterparty monitoring, contract enforcement, and communication. Accordingly, OIG recommends that FHFA should consider:

1. coordinating with Government National Mortgage Association (Ginnie Mae) on best practices related to how long an independent public accountant (IPA) may audit a counterparty before it must be replaced;
2. issuing guidance limiting the number of years that an IPA can audit a counterparty's annual financial statement before it must be replaced;
3. ordering the Enterprises to require IPAs to perform supplemental compliance tests;
4. ordering the Enterprises to increase their monitoring of counterparties that exhibit abnormal or unusual characteristics;

5. implementing guidance to the Enterprises that will govern their discretion to waive contractual obligations of counterparties. Such guidance should include requirements for: detailed written analysis of justifications for waivers; written descriptions of required corrective action plans — with dates by which compliance will be achieved — to avoid the need for future waivers; short timeframes for all waivers; and monitoring steps to assure that corrective action plans have been satisfied;
6. requiring the Enterprises to share — between themselves and with FHFA, Ginnie Mae, and other interested entities — negative performance and compliance data, and evidence of illegal activities of counterparties. Additionally, in furtherance of this recommendation, FHFA needs to monitor the Enterprises' sharing and prohibit the formation of nondisclosure agreements with terminated or suspended counterparties; and
7. ordering the Enterprises to require — by means of their seller/servicer agreements — counterparties to implement corporate governance procedures that direct chief risk officers (and internal auditors) to report illegal activities, compliance violations, and unresolved suspicions of the same to both the chief financial officer and the board of directors.

I would appreciate receiving FHFA's response to OIG's recommendations by October 31, 2014.

Peter Emerzian, Senior Policy Advisor, Michael Najjum, Senior Policy Advisor, and Bryan Saddler, Chief Counsel, prepared the attached paper. You and your staff may contact them with any questions or requests for additional assistance.

Cc: Eric Stein, Chief of Staff
John Major, Manager of Internal Controls and Audit Follow-up

TBW-COLONIAL INVESTIGATION LESSONS LEARNED

Introduction

This paper is intended to extract lessons learned from a multifaceted fraud scheme perpetrated by officers and employees of Taylor, Bean & Whitaker Mortgage Corporation (TBW) and Colonial Bank (Colonial). The fraud caused billions of dollars in losses to victims, including the Federal Home Loan Mortgage Corporation (Freddie Mac), and resulted in substantial criminal penalties for conspirators.

As an agency that participated in the investigation of the fraud scheme and as the oversight organization of the regulator/conservator of one of the key victims of the conspirators, OIG determined that — to prevent a recurrence of the events of 2003 through 2009 — it is important to: (1) discuss the fraud scheme, its ramifications, and indicators that could have mitigated it if they had been heeded; and (2) synthesize lessons learned from the experience. Accordingly, this paper begins with a short description of TBW and Colonial. Next, it discusses how the conspirators' multifaceted fraud scheme evolved. Then, it explains how the fraud scheme was discovered and stopped. Finally, it describes indicators that — had they been appropriately analyzed and acted on — could have mitigated the extent and impact of the fraud scheme, and lessons that can be learned from the failure to heed earlier warnings.

Background

On July 27, 2011, Lee Bentley Farkas, former Chairman of TBW, was sentenced to 30 years in prison, concluding one of the most significant fraud investigations resulting from the 2007-2008 housing finance crisis. Farkas and his co-conspirators at TBW and Colonial defrauded multiple financial institutions, causing billions of dollars of losses throughout the course of seven years.

TBW began business in 1982 and was purchased by Farkas in 1990. At one time, TBW was the largest privately held mortgage company in the United States, employing over 2,000 people in multiple states. TBW originated loans for homebuyers or purchased them from smaller mortgage companies, and then sold the loans to investors, such as Freddie Mac.[1] Alternatively,

[1] On April 1, 2002, the Federal National Mortgage Association (Fannie Mae) terminated TBW's status as an approved seller/servicer, and on April 4, 2002, Fannie Mae and TBW signed a non-disclosure agreement. At the time, loans sold to Fannie Mae represented 85% of TBW's business. Fannie Mae cancelled TBW's approval, after learning that Farkas personally had taken out eight loans — amounting to $2 million — to finance the repurchase of non-compliant loans that TBW had sold to Fannie Mae. The eight purported mortgage loans were not backed by homes or other eligible collateral. In other words, Fannie Mae caught Farkas selling to the Enterprise eight loans whose proceeds were to be used to finance TBW's obligation to buy back from Fannie Mae other defective loans that it had previously sold. The bogus loans came to Fannie Mae's attention when Farkas failed to make payments on them.

Fannie Mae did not formally advise Freddie Mac, its regulator, or other interested entities about TBW's termination, and following its termination TBW dramatically increased the volume of its business with Freddie Mac.

TBW consolidated its loans into pools, securitized the pools as mortgage backed securities (MBS) guaranteed by the Government National Mortgage Association (Ginnie Mae),[2] and marketed the guaranteed MBS to investors.

Colonial served as TBW's warehouse lender, funding TBW's loan originations and purchases. Specifically, TBW borrowed interim operating funds from Colonial's Mortgage Warehouse Lending Division (MWLD) in Orlando, Florida. After TBW's loans were sold to investors, it would pay back Colonial.

As of August 3, 2009, TBW serviced a mortgage portfolio of approximately 512,000 loans with an aggregated remaining principal balance (RPB) exceeding $80 billion.[3] Freddie Mac had purchased from TBW and owned many of these loans, and many additional TBW loans were included in Ginnie Mae-guaranteed MBS pools. Pursuant to its sales agreements, TBW committed to stand behind the quality of all of the loans. Freddie Mac requires sellers to represent and warrant that the loans they sell to it comply with its underwriting and other eligibility requirements. If Freddie Mac later determines that a seller deviated from such representations and warranties, then it has the contractual right to require the seller to repurchase or buy back the defective loan(s). Similarly, Ginnie Mae's guarantee agreements with issuers of MBS empower it to require them to purchase defective loans out of Ginnie Mae-guaranteed MBS pools.

Of course, these repurchase remedies are ineffective if a seller proves to be inadequately capitalized or — worse — defunct. Accordingly, Freddie Mac lost over a billion dollars on defective loans that TBW sold it, after TBW's below-described frauds were uncovered and the firm ceased operations. Likewise, the Federal Housing Administration and Ginnie Mae lost millions on defective loans placed in MBS pools that were guaranteed by Ginnie Mae.

The Fraud Schemes

TBW's fraudulent activities started small but quickly grew in size and sophistication. A multi-agency investigation determined the fraud evolved through five distinct phases. The **first phase**, which is commonly referred to as the "sweeping" phase, began in early 2003 and involved covering up overdrafts in TBW's master

> An **overdraft** is an extension of credit from a financial institution that occurs when the available balance of an account reaches zero. An overdraft allows the account holder to continue withdrawing money even though the account has no funds in it.

[2] Ginnie Mae guarantees only MBS backed by federally insured or guaranteed loans (*i.e.*, loans insured or guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, the Department of Agriculture's Rural Development, or the Department of Housing and Urban Development's Office of Public and Indian Housing).

[3] *See* Freddie Mac Proof of Claim in TBW's bankruptcy, Case No. 3:09-bk-07047-JAF, dated June 14, 2011.

operating account, which was maintained by Colonial. At the end of each day, Colonial co-conspirators would determine the amount of TBW's ongoing overdraft and transfer funds from other TBW accounts to its master operating account to cover the overdraft. The following morning, the Colonial co-conspirators would transfer the same amount of funds back to the accounts from which they had been diverted.[4]

The sweeping fraud was not detected by Colonial management because Colonial MWLD Director Catherine Kissick and Operations Supervisor Teresa Kelly performed the daily sweeps. TBW was the MWLD's largest customer and Kissick, as the Director, did not want to lose it as a customer. Both Kissick and Kelly initially believed the overdrafts were temporary and TBW would start managing their money better and the overdrafts would stop. There were numerous emails from Kissick and Kelly pleading with Farkas to stop the overdrafts, but they continued because Farkas had placed Kissick and Kelly in an unenviable position where they could not refuse to continue the daily account sweeps for fear of being exposed to Colonial management and law enforcement.[5]

In December 2003, TBW's rolling overdraft had grown to over $120 million and the sweeping scheme had become increasingly unmanageable, and thus the **second phase** of the fraud — or Plan B — was initiated. Plan B moved the overdraft fraud from TBW's accounts maintained by Colonial to Colonial's "COLB" account, which was used to buy individual loans from TBW, pending their subsequent resale to investors. By moving the $120 million overdraft to COLB, Farkas, Kissick, and Kelly were able to obscure the $120 million overdraft with fake loans or loans that had already been sold to someone else. In other words, the co-conspirators paid off the overdraft in TBW's master operating account by having TBW sell an equal value of phony loans to Colonial's COLB account.[6]

Plan B did not resolve TBW's practice of spending more than it earned, however, and its rolling overdraft continued to expand. By 2005, the amount of the fraud had more than doubled to $250 million; accordingly, Colonial held over $250 million worth of fake or previously disposed loans on their books. Moreover, loans held on the COLB account had to be sold within 90 days. This meant that the problematic loans had to be continually replaced/recycled, which again became unmanageable and led to the third phase of the fraud.

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[4] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcripts of Teresa Kelly, Catherine Kissick, and Raymond Bowman.

[5] Farkas — paraphrasing an old banking proverb — once joked, "If I owe someone a dollar I have the problem, but if I owe someone $1 million they have the problem." *See* Farkas trial, Case No. 1:10-cr-00200-LBM, Transcript of Bowman.

[6] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcripts of Kelly and Kissick.

The **third phase** of the fraud involved the Colonial Assignment of Trade (AOT) account. Like the COLB account, the AOT account warehoused TBW loans pending resale to investors. The key difference between the COLB and AOT accounts, however, was volume. Under the COLB account Colonial purchased individual loans from TBW; conversely, under the AOT account Colonial purchased pools of loans.[7] With this volume from bulk sales, Farkas, Kissick, and Kelly moved the $250 million overdraft from the COLB account to the AOT account, and simultaneously attempted to decrease the level of fictitious data that backstopped the phony and previously sold loans.[8]

The AOT account loan pools were supposed to be presold to investors and had to be off of Colonial's books within 30 days; thus, they did not receive the same level of scrutiny from Colonial's regulators and auditors as did loans in the COLB account. Further, only a limited amount of Colonial employees had access to the loan-level detail for collateral in the AOT account. As a consequence, the overdrafts continued to grow, and by 2009 there were over $500 million worth of problematic loan pools on Colonial's books.

> **Commercial paper** refers to an unsecured, short-term debt instrument typically issued by a corporation to finance accounts receivable or inventories, or to meet short-term liabilities.

After effectively stealing hundreds of millions of dollars from Colonial, Farkas expanded his illicit efforts to other victims in the **fourth phase**. Farkas created Ocala Funding (OF), which was owned and operated by TBW; OF had no employees of its own. Ostensibly, OF was created as a supplemental warehouse line of credit and sold commercial paper to investor banks. The proceeds of the commercial paper were supposed to be used to fund the origination or purchase of loans that would be subsequently sold to investors, in order to repay the commercial paper debt. In 2009, BNP Paribas (BNP) and Deutsche Bank (Deutsche) purchased $1.7 billion in commercial paper from OF. The commercial paper was purportedly backed by mortgages originated or purchased by TBW and cash with a combined value of at least $1.7 billion. But, the commercial paper was not backed by appropriate collateral, and Farkas and his co-conspirators diverted almost all of the

[7] The conspirators' position was that the loan-level data needed to support loan pools should be less detailed than that needed to support individual loans. In other words, when more Colonial money is at risk, Colonial should require less documentation. As shown in *Observations and Red Flags*, below, Colonial's Risk Control Division unsuccessfully challenged the conspirators' position on the level of support that should be obtained for loans on the AOT account.

[8] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcripts of Kelly and Kissick.

$1.7 billion in proceeds, significantly impacting the value and liquidity of BNP's and Deutsche's investments.[9]

The **fifth phase** of the fraud involved TBW's efforts to save Colonial from insolvency, through the use of the Troubled Asset Relief Program (TARP). By the end of 2008, Colonial was in desperate financial shape, and it applied to the U.S. Treasury for $553 million in TARP funding. Its application was tentatively approved with the condition that it raise $300 million from outside investors. Farkas recognized that if Colonial failed to raise the investment capital, TBW's frauds would be uncovered. Accordingly, Farkas agreed to put up $150 million and help raise another $150 million. He did this through "Project Squirrel," which diverted funds from OF.[10]

<u>The Investigation and Prosecution</u>

An investigation was initiated when Colonial issued a SEC Form 8K that indicated that TBW planned to raise $300 million to enable Colonial to receive the $550 million in TARP funds. On the basis of a hunch, investigators sought to test whether the $300 million was a "round trip transaction" — and potentially accounting fraud — whereby Colonial would loan TBW $300 million and TBW would return the funds to Colonial to meet the $300 million investment condition associated with its application for $550 million in TARP funds. In other words, investigators tested whether the $300 million "investment" was a sham that did not increase Colonial's capital. Evidence of a round trip transaction was not adduced, but the investigation caused various co-conspirators to come forward and reveal details of the above-described multi-phase fraud.[11]

One year after the investigation was initiated, Farkas was indicted and arrested on 14 counts of conspiracy, wire fraud, bank fraud, and securities fraud.

<u>Harm Caused by of the Fraud</u>

TBW's fraud caused tremendous harm to a variety of persons and businesses:

- Deutsche Bank and BNP Paribas together lost over $1.5 billion, due to the fraud related to OF commercial paper.[12]
- In its June 2011 SEC Form 8K, Freddie Mac stated that it had filed a $1.78 billion proof of claim in TBW's bankruptcy as a result of pending and projected repurchase

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[9] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcripts of Desiree Brown, Paul Allen, and Sean Ragland.

[10] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcripts of Brown and Allen.

[11] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcript of Brown.

[12] *See* Farkas Restitution Order in Case No. 1:10-cr-00200-LBM.

obligations, funds deposited with Colonial related to Freddie Mac-owned or -guaranteed loans, and miscellaneous expenses.

- In 2010, Ginnie Mae bought over $4 billion of non-performing TBW loans out of its guaranteed MBS pools and increased its applicable reserve for losses by $720 million to prepare for anticipated losses.[13]
- Colonial, once the 26th largest bank in the United States, was rendered insolvent. Colonial's insolvency caused a $3.8 billion loss to the FDIC's Deposit Insurance Fund. Further, as Colonial closed 346 offices across five states, its employees lost their jobs. Additionally, Colonial's investors and employees lost the value of their investments in Colonial as its stock value plummeted.[14]
- TBW was one of the largest employers in Ocala, Florida. When it closed, it had over 2,000 employees. They lost their jobs and Ocala's economy was severely impacted.

Observations and Red Flags

Although TBW's fraud was discovered based upon an unsubstantiated hunch about a round trip transaction, there were several unheeded red flags that should have alerted investors and regulators to actual problems. Such red flags included the following items.

Changing Charters and Regulators. Colonial changed charters and therefore changed regulators three times over the course of a decade. The identity of a bank's regulator is largely dependent upon its charter, *i.e.*, national banks, federal savings associations, and U.S.-located branches of foreign banks are regulated by the Comptroller of the Currency (OCC);[15] the Federal Reserve regulates state-chartered banks that are members of the Federal Reserve Bank System, bank holding companies, and foreign branches of member banks;[16] and state-chartered banks and thrifts that are not members of a Federal Reserve System are regulated by a state regulator and the FDIC.[17] In 1997, Colonial's regulator was FDIC and it changed its charter by becoming a member of the Federal Reserve System in order to change its regulator to the Federal Reserve Bank of Atlanta (FRB-Atlanta). In 2003, Colonial again changed it charter. This time it changed from a state-chartered bank to a national bank in order to change its regulator from FRB-Atlanta to the OCC. Then, in June of 2008, Colonial again changed its charter, reverting to a state-chartered bank in order to change its regulator back to FDIC from the OCC.

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[13] Ginnie Mae FY 2010 Financial Statements, footnotes C and H.

[14] FDIC-OIG Colonial Bank Material Loss Review No. MLR-10-031, dated April 2010.

[15] *See* http://www.occ.gov/about/what-we-do/mission/index-about.html.

[16] *See* http://www.federalreserve.gov/pf/pdf/pf_5.pdf.

[17] *See* http://www.fdic.gov/about/learn/symbol/.

The 2008 charter change occurred during the pendency of an OCC management review. As part of this management review, OCC proposed a Cease and Desist Order that addressed various deficiencies or problems with Colonial's accounting, policies, procedures, reporting and management information systems, Allowance for Loan and Lease Losses, and credit risk management of the MWLD operation.

OCC apprised FDIC of its tentative findings and that it was in the process of issuing a Cease and Desist Order. Although FDIC began to follow up on this information, it did not take enforcement action or otherwise restrict Colonial's activities.

Counterparty Monitoring. It is essential to monitor continuously the performance of counterparties and evaluate the risks associated with continuing business relations with them. In TBW's case, Fannie Mae, Freddie Mac, and Ginnie Mae each performed some level of oversight monitoring, and each encountered or should have encountered issues of concern. Their responses, however, differed widely.

> Fannie Mae Termination. In January 2000, a Fannie Mae executive discovered that TBW, from which Fannie Mae had been purchasing loans, had pledged to a third party the same loans that had purportedly been sold to Fannie Mae. After studying the issue for nearly two years — including discovering that Farkas personally had taken out \$2 million worth of mortgage loans that were not backed by homes or other eligible collateral to finance the repurchase of non-compliant loans that TBW had sold to Fannie Mae — Fannie Mae terminated TBW's right to sell loans to the Enterprise, but it did not formally advise Freddie Mac or its regulator about TBW's termination.[18]
>
> Fannie Mae's competitor, Freddie Mac, noted the cessation of TBW's business relationship with Fannie Mae, and — with very little in the way of due diligence — viewed it as a business opportunity. Its due diligence essentially consisted of discussions between a Freddie Mac employee, Farkas, and representatives from Colonial.
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> Freddie Mac commenced a self-described "special relationship" with TBW in May 2002. In that regard, Freddie Mac entered into a seller/servicer agreement with TBW — specifically, Freddie Mac agreed to purchase mortgages from TBW and then hire TBW to service some or all of those mortgages. Further, during the initial 90 days of this relationship, TBW's sales volumes doubled: its servicing portfolio RPB increased from approximately \$650 million to \$1.3 billion. Over the course of the next six years, or until 2008, Freddie Mac permitted TBW's volume limit to increase to \$34.5 billion. Nonetheless, throughout its "special relationship" with TBW, Freddie Mac was aware of weaknesses in TBW's operations. As early as August 2002, Freddie Mac personnel

[18] OIG Audit Report No. AUD-2012-007 (September 18, 2012), footnote 10.

identified deteriorations in TBW's financial condition, discrepancies in its financial statements (*e.g.*, the failure to report warrants that, if exercised, would have severely depleted its reported equity), the loss of a major source of earnings, and a negative cash flow position. Yet, Freddie Mac did not adequately increase its monitoring of TBW or place restrictions on its operations.

Freddie Mac Contract Enforcement. As a condition of selling loans to Freddie Mac, lenders represent and warrant that their loans comply with the Enterprise's underwriting requirements. If Freddie Mac later determines that the lender did not comply with such requirements, then Freddie Mac has the right to demand that the lender repurchase the loan(s) at par value. Failure to repurchase can lead to termination of a lender's right to sell loans to Freddie Mac or lesser sanctions such as collateral demands.

During the first half of 2009, Freddie Mac had substantial outstanding repurchase demands pending with TBW. Because many of these demands had been pending for a substantial period of time, Freddie Mac also demanded that TBW post collateral. TBW did not comply with these demands, and the business side of Freddie Mac opposed punishing TBW's contumacy.

Meanwhile, Freddie Mac's former Chief Risk Officer had identified several "red flags" indicating potential counterparty risk issues, including:

- TBW was very thinly capitalized; and
- TBW did not have the capability to ensure that Freddie Mac's loan eligibility standards were met.

Further, the former Chief Risk Officer advised that he was shocked when he learned that — in spite of its refusal to satisfy its repurchase responsibilities and comply with Freddie Mac's collateral demand — TBW had announced that it was going to raise $300 million in capital for Colonial.[19]

Nonetheless, Freddie Mac's board of directors did not receive detailed reports about TBW's lagging performance and refusal to remedy defective loans that it had sold, the business side's and Chief Risk Officer's differing perceptions of TBW, or TBW's announced investment in Colonial. Hence, the board of directors was unable to ensure that Freddie Mac enforced its sales agreements with TBW, and the Enterprise suffered significant losses when TBW failed and no longer had the capacity to fulfill its repurchase obligations.

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[19] OIG interview of Raymond Romano, dated March 3, 2011.

Ginnie Mae Net-funding. Ordinarily, when a loan is refinanced, the borrower's old loan is paid in full at the closing of the new loan. The proceeds of the new loan are the source of the old loan's pay off. In contrast, TBW often "net-funded" old and new loans when it was the lender and/or servicer of both. In TBW's alternative practice, it would pay off the old loan when the new loan was sold. This alternative practice resulted in: (1) the need for no or very little additional funding to finance the closings of new loans; and (2) borrowers unknowingly remaining responsible for both their old and new loans, pending the subsequent sales of their new loans and pay-offs of their old loans.

When TBW's business collapsed in August 2009, there were at least 788 of these net-funded loans that had been closed. For each of these loans, TBW serviced the borrowers' old loans, which were owned by investors in Ginnie Mae-guaranteed MBS pools. Of the borrower's new loans, 751 had not been sold to an investor when TBW became defunct. TBW serviced 746 of them, and RoundPoint serviced the remaining 5. Other servicers serviced the additional 37 new loans that had been sold to investors. When TBW shut down, its loan servicing responsibilities were shifted to other servicers and the net-funding practice was discovered.[20]

Naturally, the borrowers — who were not fully apprised of the ramifications of TBW's net-funding practice — failed to make payments on their old loans as they commenced making payments on their new loans following their closings. This circumstance went undetected as long as TBW serviced the majority of the old loans. However, when TBW ceased operations, and Ginnie Mae took over the MBS pools that it guaranteed, Ginnie Mae discovered the delinquent net-funded loans.

Although TBW's net-funding practice violates sections 5.02 and 6.04 of Ginnie Mae's Handbook 5500.3 Rev-1, and involves the financial management of Ginnie Mae's guaranteed MBS pools, Ginnie Mae and its monitoring contractor failed to discover the practice prior to TBW's demise. Robust monitoring of the MBS pools' Principal and Interest accounts could have detected the payment discrepancies among the old loans, pending their subsequent payoff.

Waiving Contract Compliance. In August 2008, TBW reported to Ginnie Mae delinquency rates for loans that it originated/sold/serviced that exceeded quality ceilings established by Ginnie Mae.[21] Nonetheless, until TBW's collapse one year later, Ginnie Mae routinely waived applicable guidelines and granted additional commitment authority, which allowed TBW to increase rapidly its business volume. Similarly,

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[20] TBW bankruptcy Order, Case No. 3:09-bk-07047, dated February 24, 2010.

[21] Ginnie Mae Issuer Review Board- Program Office Commitment Authority Request Memorandum-Justification No. J, dated September 19, 2008, and October 17, 2008.

although — as described above — Freddie Mac was aware of circumstances that raised serious questions about TBW's capitalization, capacity, and compliance with repurchase obligations, it effectively waived its applicable guidance and allowed TBW to expand its business volume.

Abnormal Growth Rates. Although Fannie Mae represented TBW's biggest counterparty, comprising 85% of its secondary market sales at the time Fannie Mae terminated its sales authority, and although secondary market sales were a crucial factor in TBW's business model (*i.e.*, if loans were not sold off of TBW's and Colonial's books and into the secondary market, then liquidity would dry up and in turn TBW's new originations would grind to a halt), TBW's business volume expanded at an unprecedented rate following Fannie Mae's revocation of its authority to sell loans to Fannie Mae.

MBS pools are not static. Once originated, they gradually decrease in size as the debt outstanding on the loans that comprise the pools is paid off — either periodically according to the amortization schedule or in full because of a sale or other reason. This diminution of the underlying debt is a useful measure of a loan seller/servicer's overall volume of business and is often referred to as the remaining principal balance or RPB. From December 2003 to June 2008, the RPB of loans originated/sold/serviced[22] by TBW increased by $60 billion. From December 2003 to December 2005, TBW's RPB grew from $6.2 billion to $21.6 billion, which essentially represents a doubling of its business volume on an annual basis. Then in 2007, TBW's business volume more than doubled as its servicing portfolio RPB increased by appropriately $25 billion. This 2007 surge is all the more astounding when one considers it in the context of the time: in 2007, as the housing finance crisis was intensifying, business volumes for other lenders of TBW's size were retreating.[23]

Prudent organizations persistently analyze counterparty risk. In light of the extraordinary growth of TBW's business volume, it would have been reasonable for its counterparties to thoroughly evaluate the risk that TBW had the resources (*i.e.*, interim funding pipeline) and capacity (*i.e.*, staff and systems) to handle the deluge it was confronting. In hindsight, TBW did not have the resources and capacity and its counterparties suffered losses as a result of their failure to timely detect these facts.

> **Counterparty risk** is the risk that a party to an agreement or contract will not fulfill the party's obligations. Credit risk is a type of counterparty risk associated with financial obligations.

[22] TBW retained the servicing rights on a large proportion of the loans it originated/sold.

[23] Standards & Poor's Servicer Evaluation: Taylor, Bean & Whitaker Mortgage Corporation, dated October 27, 2008.

Internal Controls. Typically financial institutions' internal controls will reveal fraud by customers or employees, but such controls may not be as effective when there is collusion between customers and employees. As Colonial's CFO testified, "[i]f a bank employee and a bank customer are working together, it's very difficult to find errors or omissions or things going on because it's a vertically integrated effort. So, the customer is typically a check on the bank employee and the bank employee is a check on the customer. But if those two are working together, it makes it very difficult to find any issues." Because Kissick, Kelly, Farkas, and others conspired to commit various frauds, they were able to overcome Colonial's basic internal controls.[24]

> **Internal controls** relate to an organization's plans, methods, and procedures used to meet its mission, goals, and objectives and include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

However, as a counter-measure to such customer-employee collusion, organizations often deploy internal auditing or review programs. Colonial created the Risk Control Division (RCD), which raised concerns about TBW's master operating account maintained by Colonial and the AOT account. In the latter regard, the RCD attempted to obtain loan-level detail of loans on the AOT account and was rebuffed by Kissick. This caused greater suspicion on the part of the RCD, but it had no way to resolve its suspicion because Colonial's reporting structure required it to report its findings to Kissick's supervisor as opposed to the CFO or another chief executive (outside of the business line) and to the board of directors.

Lessons Learned

Three evident areas for improvement that the TBW-Colonial fraud exemplifies are: counterparty monitoring, contract enforcement, and communication.

1. Improved Monitoring.

The Enterprises can improve their monitoring of counterparties, particularly non-regulated counterparties.[25] Such monitoring can be improved, among other means, by rotating independent public accountants (IPAs), instructing IPAs to test compliance with the Enterprises'

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[24] Farkas trial, Case No. 1:10-cr-00200-LBM, Transcript of Sarah Moore.

[25] The majority of the Enterprises' mortgage lender counterparties are depository institutions, their subsidiaries, and nonbank mortgage companies. Depository institutions are regulated by the FDIC, the OCC, or the National Credit Union Administration. Nonbank mortgage companies specialize in the origination, sale, and/or servicing of real-estate mortgage loans, and they are not regulated by aforementioned financial regulators.

seller/servicer guides,[26] and focusing/increasing monitoring activities related to counterparties that reflect abnormal or unusual characteristics (*e.g.*, frequent charter changes or extraordinary growth).

Rotating IPAs. Enterprise and Ginnie Mae guidelines require seller/servicer/issuer counterparties to hire IPAs to audit their annual financial statements and submit the audit reports to the Enterprises and Ginnie Mae for consideration. However, these audits are only as good as they are independent, and to ensure independence FHFA should consider coordinating with Ginnie Mae on best practices related to how long an IPA may audit a counterparty before it must be replaced.

The length of time an IPA audits a counterparty can be indicative of a problem. If a counterparty changes IPAs routinely, then it could be trying to prevent IPAs from becoming too familiar with its operations. Alternatively, if a counterparty uses the same IPA year-after-year, then questions of collusion or competence may arise.[27] The intended recipients of an IPA's audits should consider the amount of audits that the IPA has performed for a given counterparty, and FHFA should consider issuing guidance limiting the number of years that an IPA can audit a counterparty's annual financial statement before it must be replaced.

Supplemental Compliance Tests. The Enterprises can improve the value of IPAs' audits — and in turn the quality of their monitoring — by requiring supplemental compliance testing. These supplemental tests could be implemented one of two ways: (1) ordinary testing of a management certification of compliance, or (2) agreed-upon procedures.[28] Under the first alternative, as part of the process of auditing its annual financial statement, counterparty management would certify that the counterparty complied with the Enterprises' guidelines over the course of the audit period, and the IPA would then be obligated to test the accuracy of the counterparty's certification. IPAs would exercise professional

Pursuant to an **agreed-upon procedures** audit engagement, the audit client engages an IPA to assist a third party to resolve information needs of the third party. Because the third party requires that the information be independently derived/verified, the services of an IPA are obtained to perform the procedures specified by the third party.

[26] Supplemental compliance testing should be conducted and reported in accordance with Generally Accepted Auditing Standards.

[27] TBW used the same IPA from 2003 through 2009.

[28] OIG will soon complete an audit, and issue a report, concerning FHFA's oversight of the Enterprises' information used to oversee compliance with origination and servicing standards, which will further elaborate on this sort of supplemental testing.

discretion when selecting items to test and planning test steps.

Under the second alternative, the Enterprises would devise and publish "agreed-upon procedures" for IPAs to implement as part of their annual financial statement audit process. The agreed-upon procedures would focus on seller/servicer requirements that the Enterprises deem to present a material risk of loss. Freddie Mac required counterparties to engage IPAs for similar agreed-upon procedure tests until October 1995.

FHFA should consider ordering the Enterprises to require IPAs to perform supplemental compliance tests.

<u>Abnormal Characteristics</u>. The Enterprises can improve the quality of their counterparty monitoring by elevating their oversight of counterparties that exhibit abnormal or unusual characteristics, such as frequent charter/regulator changes or sudden extraordinary growth in business volume. The potential that such abnormal characteristics may be associated with funding, capacity, or other typical counterparty risks that could frustrate counterparties' fulfillment of their contractual obligations weighs heavily in favor of increased supervision.

FHFA should consider ordering the Enterprises to increase their monitoring of counterparties that exhibit abnormal or unusual characteristics.

2. Contract Enforcement.

In contrast to Fannie Mae, which terminated TBW's authority to sell it loans when it determined that TBW had audaciously attempted to remedy its sale of defective loans to Fannie Mae by selling it more defective loans, Freddie Mac and Ginnie Mae continued to waive guidelines and grant additional commitment authority for TBW in spite of information indicating that TBW represented a heightened risk. Indeed, in Freddie Mac's case, it continued to purchase loans from TBW and allowed it to expand its business volume notwithstanding TBW's failure to satisfy substantial outstanding repurchase demands and to post collateral.

In view of Freddie Mac's experience, FHFA should consider implementing guidance to the Enterprises that will govern their discretion to waive contractual obligations of counterparties. Such guidance should include requirements for: detailed written analysis of justifications for waivers; written descriptions of required corrective action plans — with dates by which compliance will be achieved — to avoid the need for future waivers; short timeframes for all waivers; and monitoring steps to assure that corrective action plans have been satisfied.

3. Increased Communication.

Although rigorous counterparty monitoring and contract enforcement are indispensable, the TBW-Colonial fraud also reveals that various actors were victimized because they didn't learn of or from the experiences of others. In retrospect it appears obvious that Fannie Mae, Freddie Mac, Ginnie Mae, and FDIC should have shared their experiences with counterparties among themselves and they should have learned from each others' experiences. However, these obvious points were not implemented in the TBW-Colonial scenario. Additionally, Freddie Mac and Colonial demonstrated that problems need to be conveyed adequately to the highest levels of executive management within counterparties. Given that Fannie Mae and Freddie Mac did not self-initiate one or more of these straightforward internal controls, FHFA should consider imposing them.

Sharing Information Externally. As discussed above, Fannie Mae did not formally apprise Freddie Mac, its regulator, or Ginnie Mae of its termination of TBW, and Freddie Mac did not adequately delve into the reasons for TBW's cessation of its business relationship with Fannie Mae. Had it done so, it would have learned that TBW had twice been caught selling defective loans to Fannie Mae. Knowing these facts, it would have been an extraordinary exhibition of hubris or naivety for Freddie Mac not to take special precautions against TBW selling it defective loans.

Similarly, FDIC did not take adequate precautions to protect itself from the tentative findings of OCC's 2008 management review. Hence, significant concerns regarding Colonial's accounting, policies, procedures, reporting and management information systems, and credit risk management were not resolved, and the TBW-Colonial fraud continued for another year.

FHFA should consider requiring the Enterprises to share — between themselves and with FHFA, Ginnie Mae, and other interested entities — negative performance and compliance data, and evidence of illegal activities of counterparties. Additionally, in furtherance of this recommendation, FHFA needs to monitor the Enterprises' sharing and prohibit the formation of nondisclosure agreements with terminated or suspended counterparties.

Disseminating Information Internally. Risk officers within Freddie Mac and Colonial were confronted with red flags related to TBW's and Colonial's problematic activities. Yet, they failed to elevate this information to the highest levels. Within Freddie Mac, the Credit Risk Officer wrangled with the business side about how to resolve pending demands for TBW to repurchase defective loans and post collateral. Their differing view points were not brought to the attention of the board of directors, however, and a standoff between the offices persisted until the time of TBW's failure.

With respect to Colonial, the risk officer had questioned the loan-level detail of loans on the AOT, where the conspirators had parked over $500 million worth of phony loans. However, he was prevented from resolving his questions because Colonial's reporting structure required him to report his findings to the supervisor of one of the conspirators as opposed to a disinterested chief executive and/or the board of directors.

FHFA should consider ordering the Enterprises to require — by means of their seller/servicer agreements — counterparties to implement corporate governance procedures that direct chief risk officers (and internal auditors) to report illegal activities, compliance violations, and unresolved suspicions of the same to both the chief financial officer and the board of directors.