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College of Law, Rafael Diaz-Balart Hall

11200 S.W. 8th Street

Miami, Florida 33199

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BYRON S. GEORGIOU, Commissioner

HON. SENATOR ROBERT GRAHAM, Commissioner

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P R O C E E D I N G S

COMMISSIONER GRAHAM: This meeting of the Financial Crisis Inquiry Commission is called to order. I would like to introduce our chair, distinguished Phillip Angelides.

CHAIRMAN ANGELIDES: Good morning. Thank you, Senator Graham, and thank you each and every one of you for being here this morning at this public hearing of the Financial Crisis Inquiry Commission. with no further adieu, I'd like to start off today by asking Dean Alex Acosta to come forward and greet us on behalf a Florida International University, the College of Law.

Thank you, Dean.

DEAN ACOSTA: Thank you, Mr. Chairman.

Mr. Chairman, Mr. Vice President, and Members of the Commission, welcome to Florida International University's College of Law. I want to thank you for the critical work you're doing. Today's topic of mortgage fraud is an important one.

Prior to becoming Dean, I served as a United States Attorney here in South Florida for five years. I am far too familiar with the pernicious impact of mortgage fraud in our community and our nation. In 2007 I started a mortgage fraud task

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force combining federal and state authorities and it was successful and it investigated and it prosecuted mortgage fraud, and it continues to be in force today.

That said, prosecutorial success is not the answer. Preventing mortgage fraud before it happens in the first place is far more important than prosecuting it after it happens. Prevention is better than prosecution.

Now, as Law Dean, I see mortgage fraud from a very different perspective. Just yesterday upstairs a student approached me and asked to start a foreclosure clinic. Thousands of individuals are losing their homes, he said, and we as law students as future members of the Bar should help. He's right.

Here at FIU's College of Law, we started last year a bankruptcy clinic. Our students are working with the Florida Bar to help individuals who need to file bankruptcy yet whose financial resources are so limited, they can't afford to hire a lawyer. Here at FIU's College of Law, we started this year a small investment fraud clinic. Our students were to help small investors, often retirees who have

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lost their savings due to misconduct by broker/dealers. Yet these individuals have savings so small that no lawyer will take their case even on contingency. The need is there and the need is there in large part because of the financial crisis that your Commission is charged to investigate.

So as a former U.S. Attorney and now a Law Dean, I ask that when you consider today's testimony, please consider more than what is being done to prosecute mortgage fraud. Please consider what can be done to prevent this in the first place. Please consider what can be done so that today's state of affairs is not repeated in the future.

Your job is far from easy. It is a bipartisan commission. You have a special opportunity to break through the gridlock. You have an opportunity to have far-reaching impact. So I thank you for your work. FIU's College of Law stands ready to assist you in your endeavors in whatever way we can.

Thank you and welcome.

CHAIRMAN ANGELIDES: Thank you very much, Dean Acosta, and thank you very much for your gracious

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hospitality and all the help of you and your staff.

What I'd like to do now is turn this hearing over to Senator Graham. And I will just say it's a tremendous honor to be in his home state. We have a tremendous amount of admiration for Senator Graham. He's obviously made a tremendous mark on civic life in this state and on the whole country both as Governor and as a Senator in the United States Senate.

And so with no further adieu, I will hand this gavel to Senator who I know knows how to wield it judicially and well and this hearing is his.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman Angelides. It is an honor that you have decided to bring one of the hearings of this Commission to Miami. Unfortunately, as we will learn, the reason for it is that in many ways Miami is the center of a serious national scandal of predatory practices and mortgage fraud.

Before continuing, I would like to quickly introduce our guests who accompany me as members of the Commission. Starting from my right is Ms. Heather Murren of Las Vegas.

Thank you, Heather.

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To my left is Phil Angelides, Chair, from whom you will hear shortly, Mr. Bill Thomas from California, and also from Las Vegas, Mr. Byron Georgiou.

Thank you all for being with us today.

I would like to thank President Rosenberg who accepted our initial invitation to come to Florida International University as the site of this hearing and then to Dean Acosta for offering the beautiful facilities of the College of Law as our venue.

As I indicated earlier, Florida is among the states which have been most affected by the mortgage meltdown. As an example, in this South Florida region, of every 111 homes, one is in some stage of foreclosure. This compares to the nation as a whole where one out of 381 homes is in some stage of foreclosure. A shocking statistic to me and to anyone who lives in this state.

The losses to Florida's economy are directly connected to the ongoing financial crisis. With an unemployment rate of 11.6 percent, 2 percentage points higher than the national average, Florida's families and communities and its leaders are

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struggling to find means to recover.

The testimony, interviews and documents gathered by the Commission since Congress gave us our mandate last year, we have learned that from 2003 to 2006, nationally the volume of higher-risk mortgages made to borrowers more than doubled and that by 2007 and 2008 in Florida, the reported incidents of mortgage fraud and suspect lending practices had also more than doubled. We now know that Florida leads all the 50 states in the number of borrowers who misrepresented their incomes or their ability to repay mortgages, according to the Federal National Mortgage Association. Fraud and predatory practices emerged in the origination of both new mortgages and the refinancing of existing mortgage.

Today the Commission has invited experts to this hearing who can help us understand the connections between these unsavory lending practices and the waves of mortgage defaults and foreclosures in Florida and nationally. I look forward to hearing from them today. I appreciate their willingness to assist us in understanding these important and frequently complex issues.

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I want to thank my fellow commissioners for traveling to my home community to be part of this hearing and look forward to our -- to your comments and answers to our questions.

I would now return the gavel, or at least the podium, to Chairman Angelides for his opening remarks.

CHAIRMAN ANGELIDES: You've got the gavel all day long. That's yours.

So, first of all, thank you very much for having us here in Florida. And I'm going to make some very brief comments, because I'd like to get on with the testimony of the witnesses and our questions to them today on this very important issue.

Just for perspective, this Commission, The Financial Crisis Inquiry Commission, was formed in May of 2009 with the passage of the Mortgage Fraud and Recovery Act signed by the President of the United States. But we are a ten-member commission, a bipartisan commission, with an important national mission, and that is to examine the causes of the financial and economic crisis that still grips this country today.

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When we started on our journey, there were many that said that by the time our report is issued to the President and the Congress and the American people by December of this year, December 15th, that the financial crisis would be a dim memory. Unfortunately, for the people of this country, it is still very much with us and likely to be for years ahead.

As we gather today in Florida, 27 million Americans are out of work, can't find full-time work, or have stopped looking for work. Two million American families have lost their homes to foreclosure. Another two million families are in the foreclosure process. And yet another 2 million families are seriously delinquent on their loans. Eleven trillion dollars of wealth of American households has been wiped away like a day trade gone bad.

So as we meet today, this crisis is still very much with us and we are charged with trying to help the American people and policymakers have a better understanding of what brought our financial system to its knees. Over the course of the last year with the resources we've had and with the time

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given us by the Congress, we've been hard at work to try to do the work necessary to try to explain this disaster, this financial disaster for our country.

We've conducted over 700 interviews of people in communities around this country, people who sat at trading desks, people ahead of the major financial institutions of our country and the people who were charged with regulating and keeping safe our financial system.

We have reviewed millions of pages of documents, and in Washington and New York we held 14 days of hearings looking at issues like subprime lending and the growth of derivatives and the role of the credit rating agencies, and each and every one of those hearings have investigated and asked questions of the participants who are at the center of this storm.

Over the last several weeks, we've gone across this country to communities, hometowns of commissioners, that have been hard hit by the crisis. We started in Bakersfield, California, the home of the Vice Chairman, a place wracked by double-digit unemployment and rampant foreclosures.

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We went to Las Vegas, the hometown of Ms. Murren and Mr. Georgiou, a community where 72 percent of the homes are under water in terms of the home value versus the mortgage.

Today we are here in Miami, and then on Thursday of this week, we round up our hearings in my hometown of Sacramento, another community that is struggling very, very hard in the wake of the financial meltdown.

I'm looking forward to today's testimony. One of the things that from day one that I thought was central to our examination is to examine how the nature of lending went so terribly wrong in our country, how it came to be that toxic mortgages were made and how it came to be that those toxic mortgages infected our financial system. So I'm very anxious for today's hearing to learn about this issue of mortgage fraud and to learn about what happened here in South Florida.

Mr. Chairman, thank you very much for having us here today and I look forward to today's hearing.

COMMISSIONER GRAHAM: Mr. Bill Thomas, Vice Chair.

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VICE CHAIRMAN THOMAS: Thank you very much, Senator.

Pleasure to be with you once again

I have not spent a lot of time in Florida. I grew up in Southern California, especially in the '50s and the '60s and the '70s. So in terms of rapid growth and expansion, glancing over at one of our first witnesses from the University of California, Irvine -- actually I knew it as the Buffalo Ranch on the way to Bal Island on the Pacific Coast Highway back then, and that was all there was, was nothing but a Buffalo ranch. So it's a pleasure to have you as well.

Most of my research and understanding of Florida I've taken as my primary text, those textbooks written by Carl Hiaasen, to fully understand the intricacies of the way things work in Florida, especially South Florida. And although it's a lot of fun reading him, the job that we have is a very serious one.

Obviously we have to explain what happened. But in those areas of difficulty and explaining what happened, I really think to a very great degree is mortgage fraud, trying to isolate it and

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understand it. I'm interested in comments about the tools we have to measure fraud, however you define that, and what we need to do perhaps to sharpen those tools and probably make more aware the real human damage done by those who were involved in an industry, once again relying on Carl Hiaasen and my experience in Southern California.

That tends to put it in a perspective that needs to be looked at much more carefully, and I guess Miami is the best -- one of the best places to be. I understand at its height, mortgage fraud was pushing Medicare fraud out of the number one spot. But I think Medicare has recaptured the lead. Our hope is that as we learn what happened and if we can do a good job of explaining what happened, the area of fraud has no role in any activities. But when you begin to examine the way in which fraud was involved in the housing bubble and the consequence collapse of that bubble, it is something that we should never have to investigate again to try to figure out what happened to whom and when.

Thank you, Mr. Chairman.

COMMISSIONER GRAHAM: Thank you very much,

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Mr. Thomas.

I'm going to ask the witnesses to rise, as we have each of our public hearings and will today, we're asking each of the witnesses to be sworn.

Would you please raise your right hand. Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MS. FULMER: I do.

MR. PONTELL: I do.

MR. BLACK: I do.

(Witnesses sworn.)

COMMISSIONER GRAHAM: All right. In front of you, you see this small box. This is the timer. Unfortunately, what you will see will be three-colored signals of green which indicates you are speaking on your time, a yellow which means that you have one minute, and then red which means that to please conclude your remarks. Each of you will have five minutes for your openings statement to be followed by questions from the members of the Commission.

Thank you.

Our first panel is led by Ms. Ann Fulmer who is the Vice President of Business Relations at

Interthinx and Co-founder of the Georgia Real Estate Fraud Prevention and Awareness Coalition.

She will be followed by Mr. Henry Pontell, Professor of Criminology, Law and Society and Sociology at the University of California, Irvine, and finally Mr. William K. Black, Associate Professor of Economics and Law at the University of Missouri-Kansas City campus.

Thank you to each of you for your participation today.

Missouri. I'm sorry. University of Missouri, Kansas City.

Ms. Fulmer?

MS. FULMER: Thank you.

Mr. Chairman, Mr. Vice Chairman, Members of the Commission, my name is Ann Fulmer. I hold a Bachelor of Arts in Mass Media Communications and a law degree both from the University of Akron. I have studied the mortgage fraud against lenders and how to detect it and have worked diligently to prevent it since 1966 when criminals began to illegally flip houses in my neighborhood just outside Atlanta, Georgia.

In this quest I have worked as a licensed private detective, a county tax assessor as an expert witness and briefly as a criminal

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prosecutor. I also co-founded the Georgia Real Estate Fraud, Prevention and Awareness Coalition whose mission includes bringing public awareness of the crime and the damage it brings to communities.

For the past five years, I have been the Vice President of business relations at Interthinx and various analytic companies. Interthinx is a leading provider of automated fraud detection and prevention technology to the residential mortgage lending industry. In that capacity, I frequently lecture on the topic at industry conferences and have been called upon to provide training and assistance to the federal law enforcement agencies, including the FBI, the Secret Service, HUD's Office of Inspector General and federal prosecutors.

I think it's important at the outset to clearly distinguish between mortgage fraud and predatory lending, because those outside the industry frequently use the terms interchangeably.

In predatory lending cases, the borrower is the victim of the lender or broker's failure to make proper disclosure of the terms and fees associated with the loan or the loan containing terms harmful to the borrower or failure to provide

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a tangible benefit to the borrower. The majority of these cases are pursued in the civil courts, most recently as a defense of foreclosure.

In mortgage fraud cases, the victims are the lender, the communities in which it is perpetrated, and now, by virtue of the fact that more than 90 percent of loans originated today are purchased, insured and guaranteed by the federal government, directly or indirectly through Fannie's and Freddie's conservatorship, the U.S. taxpayers. Violations of mortgage fraud are prosecuted as a criminal matter.

I was a stay-at-home mom in 1996 when I first became aware of mortgage fraud against lenders. Houses in my up-scale neighborhood that had been sitting on the market for years were finally beginning to sell. I soon began to hear rumors that the purchasers were leaving the closing table with large amounts of cash and neighbors began to complain about unusual activities at these houses. The new occupants actively avoided contact with our neighbors. They did not seem to have jobs. They didn't mow their yards or keep up the houses. Some covered their garage windows with paper and others

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had a lot of late-night car traffic.

Then the neighbor told me that an IRS agent and an investigator from the State Department of Banking and Finance were investigating these sales and he asked me to help them. When I began to investigate, I discovered that a handful of people were involved in all of the unusual sales in my neighborhood; that they were buying and reselling these houses on the same day with price increases of up to $300,000; and that they were doing this in communities throughout metropolitan Atlanta.

That's when I discovered illegal flipping. In a typical flip, the perpetrator signs a contract to purchase the property at the asking price, but without making any improvements, he obtains an appraisal that shows a value that can be as much as 300 percent higher than the actual value. The perpetrator then finds an end buyer or steals someone's identify and fabricates critical information on the mortgage application in order to fool the lender who would be granting the loan. The higher priced sale to the end buyer is closed just before the perpetrator's actual purchase at a lower price and the proceeds from the higher priced

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sale are used to fund the perpetrator's purchase at the lower price. The excess funds are pocketed by the perpetrator and shared with his collaborators.

Mortgage fraud is essentially bank robbery without a gun. Its perpetrators include street gangs, drug traffickers, real estate agents, closing attorneys, appraisers, mortgage brokers, bank executives, ministers, teachers and even police officers. It can and does happen anywhere in any community in every state at any price range during rising and falling markets and it leaves these communities devastated.

The variety seems to shift constantly depending on market conditions, and flipping did play a major role in the initial escalation of housing prices which drew speculative investors and more fraud into the market to the point where houses eventually became unaffordable in many markets.

This in turn led to the abuse of stated-income and no-document loan programs, particularly through the broker mortgage channel, in order to qualify borrowers for mortgages that if they had been fully amortized they could not afford to repay.

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When the housing market began to cool in 2005, the riskiest borrowers began to default in large numbers in what came to be known as the subprime mortgage meltdown. These defaults eventually became so pervasive that investors in residential mortgage backed securities began to demand that the originators repurchase entire pools of mortgage loans.

Since most lenders were originating mortgages to sell on the secondary market, they did not have the funds available to meet investor demand, and when those lenders began to fail, it created a liquidity crisis and ultimately led to the great recession.

I will take your questions now.

COMMISSIONER GRAHAM: Thank you very much, Ms. Fulmer.

Mr. Henry Pontell?

MR. PONTELL: Thank, you Senator Graham, Chairman Angelides, and Members of the Commission.

VICE CHAIRMAN THOMAS: Pull the mic up. The mics are pretty unidirectional. Bend it towards you.

MR. PONTELL: Okay. Thank you.

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Thank you very much for the opportunity to present testimony to you today on the workings of mortgage fraud and its effects of fraud.

Senator Graham, as a side note, I should mention that about 20 years ago I testified in front of you on a Senate Banking Committee Hearing regarding the government response to savings and loan fraud. So it's nice to see you again.

As a university-based criminologist, I have studied white-collar and corporate crime for three decades beginning with the first federally funded study of medical fraud in the 1980s. Following this I was a principal investigator over the U.S. Department of Justice funded study of the causes of the Savings and Loan Crisis and government response, which produced the award winning book Big Money Crime. I have written about the role of fraud in other major financial debacles, including the 1994 Orange County bankruptcy, the 2002 corporate and accounting scandals and the current economic disaster.

My findings indicate that fraud has played a significant role in causing the financial losses that led to major debacles occurring over the past

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25 years. The only way we can effectively prevent future crises is to fully understand the nature and extent of fraud. Assigning major financial loss to "risky business" has resulted in highly destructive policymaking and ever-larger financial crisis. Lax or practically non-existent government oversight created what criminologists have labeled a crime-facilitative environment where crime can thrive.

The major losses occurring through mortgage frauds in Florida and throughout the country that brought on the current economic crisis were not due to scam artists, notwithstanding the fact that their crimes have now become collectively quite significant and warrant serious attention by authorities. Rather, the original losses were produced by large lending institutions and Wall Street companies that ran afoul of the law during endemic waves of fraud typically because of decisions that are made at the top that often exploit perverse market incentives and essentially turn the organization into a weapon with which to commit crime; Lincoln Savings and Loan and Charles Keating, Enron and Jeff Skilling and Ken Lay,

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Countrywide and Angelo Mozilo, the list goes on. All of these examples have one major factor in common. Those in charge had enriched themselves by engaging in what is known as control fraud. In other words, controlling insiders had suborned both internal and external safeguards and checks and essentially looted their own companies.

For example, the problems experienced at Countrywide Financial, the country's largest mortgage lender, that at its height, financed one out of every five American home loans -- and that has already settled a large civil case in Florida -- are illustrative of massive fraud in the industry.

A senior Vice President for the company noted in his 2009 book that its business model of a "new system of loans and refis awarded to anyone with a pulse, was, in retrospect, long-term madness driven by short-term profit." Angelo Mozilo, the company's CEO and chairman, currently faces insider trading and securities fraud charges for failing to disclose the lax lending practices and the hyping of the company when he knew it was going south. Between 2001 and 2006 he took $400 million in

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salary, stock options and bonuses from the company. Moreover, the evidence seems damming on its face. Mozilo's e-mails to insiders contain messages such as, "In all my years in the business, I have never seen a more toxic product," and "Frankly, I consider that product line to be the poison of our time."

Regarding the current crisis, one recent study analyzed the responses of persons working in brokerage, lending, escrow, title, and appraisal offices documenting the rationalizations that were used to explain their involvement in mortgage-related crimes. These individuals fed the primary epidemic of control fraud which produced echo epidemics consisting of those who purchased the nonprime product. The findings detail accounts of mortgage frauds in the subprime lending industry that resulted from inadequate regulation, the indiscriminate use of alternative loan products, and the lack accountability in the industry. Perpetrators commonly perceived many acts of mortgage fraud, origination fraud, as inseparable from conventional lending practices that are necessary in any "successful" legitimate subprime

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business. It came down to different manifestations of a common theme: "We are simply doing our jobs and getting our clients what they want. They are usually happy I got the loan for them."

It's also instructive to look back on the Savings and Loan Crisis to understand how fraud permeates major crisis. Given the best available evidence, at least one thing is certain from this sad chapter in American history. The incredible financial losses directly attributable to white-collar crimes that were discovered and recorded in official statistics on the Savings and Loan Crisis represent only the tip of the iceberg.

In terms of the current crisis, three major issues stand out. The first is that executive compensation policies turned private market discipline into perverse incentives encouraging massive control fraud even at the least -- at the most elite firms.

Second, the FBI reacted to its severe capacity problems in a manner that failed to challenge Bush administration policies that virtually guaranteed that the FBI would fail to stem the tide of fraud.

Third and finally and central to the high

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incidence of subprime fraud was the fact that no one involved in the process of evaluated credit quality. Had they done so, they could not have missed or allowed the widespread and severe nature of these frauds.

I'm happy to answer any questions you may have related to my testimony.

COMMISSIONER GRAHAM: Thank you very much, Mr. Pontell.

Mr. Black?

MR. WILLIAM BLACK: Thank you, Members of the Commission, for your invitation. My primary appointment is in economics. I have a joint appointment in law. I'm a white-collar criminologist and I'm a former financial regulator active in regulating to prevent these kinds of frauds and helping to bring about the successful prosecution in the savings and loan context.

So what is different this time around? Mortgage fraud is vastly greater than Medicare fraud in terms of losses. And we have excellent numbers on that. If you look at the credit Suisse estimate, they estimate that stated-income loans became 49 percent of total originations, new

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originations by 2006. People can debate whether it's 43 or 49, but it became huge.

Those are liar loans. We also have excellent information on liar's loans. Liar's loans, as the industry's own expert said, warrant that phrase "liar's loans" because they are, to quote them, an open invitation to fraud. And we have consistently seen fraud incidents with liar loans that starts in the high 50s and goes to 100 percent literally of the samples looked at. That means we are talking about millions of fraudulent loans. I repeat millions per year of fraudulent loans.

Now step back a moment. The Dean, in his invitation, rightly talked about prevention. This industry historically in home mortgage lending for all causes of losses, all causes, was able to keep those losses under 1 percent. We are now talking about losses in the 40 percent range. Something massively different has occurred.

And it can only come from the top and that's what control fraud is all about. Someone had to gut the underwriting. Because, for example, the loan flipping described is easy to stop. Any competent lender with honest underwriting would

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prevent all of those frauds that were described. And we did so for 40 years.

Why then do we have this change? Because here is the recipe for a lender to optimize accounting fraud, reported income and, therefore, their bonuses in the modern era, one, grow like crazy; two, make really bad loans at a premium yield; three, have extreme leverage; four, provide only trivial loss reserves.

If you do that, then both criminology, regulation, and economics from the Nobel Prize winning economist George Akerlof said you will produce, to quote Akerlof, a sure thing. You follow the strategy, you will report record profits. In the modern era, that means you will get record compensation.

So how did they do this? They put people below them on compensation systems as well, and you got absolutely rich in this industry because they didn't care about loan quality. So the compensation would pay you at times $10,000 if you would bring in a particularly high yield, which is to say definitely fraudulent loan. You could make $10,000 doing that and they are -- then would not

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look. They would not look for loan flipping. They would not use their own professional appraisers.

In fact, what did they do? At Washington Mutual, and others we know from the investigation, Attorney General Cuomo, that they had a blacklist of appraisers. But you got on the blacklist if you were honest.

So I ask you this: Why would an honest lender ever inflate or even allow to be routinely inflated appraisal values? It optimized fraudulent income, but it is suicidal for an honest lender. When you gut the underwriting, you do get all kinds of other opportunistic frauds. And I'm happy to put them in prison, but we need to put the people at the top of the food chain in prison, and I guarantee you, no one is going to put 6 million Americans in prison for mortgage fraud.

Thank you.

COMMISSIONER GRAHAM: Thank you, Mr. Black.

I am going to start the questioning and then we will ask Ms. Murren, Georgiou, to be the lead questioners for this panel.

Ms. Fulmer, you outlined particularly the flipping component of mortgage fraud. Since 2006

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and '7 when this became so publicly available and known, what has been the response of governments at the state and federal level to restrain this practice?

MS. FULMER: On flipping?

COMMISSIONER GRAHAM: Yes.

MS. FULMER: Well, actually, the market has done most of the correction on the flipping itself, because flipping really only works in a rising market. The schemes now have shifted into what we call flopping where short sale properties -- properties that are being involved in short sales -- the prices are being artificially deflated in order to create that elicit profit margin.

I think that to some extent, although it wasn't acknowledged as the purpose, the home valuation code of conduct and separation between -- the wall, I guess, between loan originators and appraisers was a step that helped reduce some of the pressure on appraisers to come in at these values.

I think that one of the things that has slowed fraud down generally is the elimination of the stated and no-documentation loan programs and

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lenders' much higher use of the 4506T which is a form that a borrower signs that allows the lender to go directly to the Internal Revenue Service and verify income. That has I think put -- slowed fraud down tremendously.

The concern that we have at Interthinx is that because schemes are constantly shifting, lenders don't always recognize up front what's going on, and that's why we're seeing the shifts into REO properties and these are being flipped, and then also in the short sale market.

COMMISSIONER GRAHAM: Did you notice any difference between new loan originations and refinancings during this period? From '05 to '07 for the first time in recent history, refinancing exceeded new financings and at one point were over twice the number of new homes being financed. Did you see a difference in the type or level of activities as between those two?

MS. FULMER: I don't have those figures from our analysts, but one of the common schemes during the boom was for a perpetrator to acquire a property using a straw borrower to on paper grant that borrower a loan from a company that in reality

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was a shell and then to present that straw borrower's application to the bank and then owner occupied cashes out and refinances it, so that what was actually a purchase transaction was shown to the bank as an owner occupied cash-out refi, and that was something that was I think started more to towards the middle of the 2000s.

COMMISSIONER GRAHAM: Mr. Pontell, the scheme that you have outlined depends upon somebody at the end of the day being willing to buy these mortgages, and typically they were firms that would buy mortgages for purposes of syndication and mortgage backed securities and other forms of collateralized derivatives.

Why were those people unaware of the quality and the process by which the mortgages that they were purchasing were manufactured?

MR. PONTELL: If I understand your question correctly, Senator, it's why were they unaware these were --

COMMISSIONER GRAHAM: Well, why did they buy and pay market rates for what appear now to be very much over-valued mortgages?

MR. PONTELL: Right.

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Well, the short answer to that question has to do with a couple of things. First, conservative ignorance on the part of those who were buying these loans. Conservative ignorance meaning that they intentionally didn't look at the quality of these loans. There was an incentive for those loans to move up the food chain and there were incentives going down.

So what I was talking about in my testimony, my written testimony, was these echo epidemics of fraud. And what happened was that there was an incentive for making these loans at the lower level and securitizing them at the upper level. So you had these perverse market conditions and people willing essentially to evaluate the credit quality. If they were, then they never would have put these securities packages together.

COMMISSIONER GRAHAM: Were there some warning signals that were available, and had they been followed, could have detected this level of fraud earlier and avoided its rampant application?

MR. PONTELL: Well, there were warnings as early as 2004. The FBI made those warnings public. But the policy that was followed was not to do what was done during the '70s loan crisis, which was to immediately create a national task force, regional task forces, that would put together regulators and enforcement agents so that they could prosecute these frauds early on. By the time the FBI did get into examining these mortgage frauds, which they're doing now, the numbers have gone up.

So you have incredible system capacity problems that could have been abated if these warning signs were taken seriously as early as 2004 when they were made public.

COMMISSIONER GRAHAM: You mentioned the failure of the FBI. Was that a failure because they didn't have adequate personnel to enforce? Were the laws ineffective against the kind of fraud that was being practiced? What was the reason the FBI was not able to rein this in?

MR. PONTELL: Well, part of it had to do with resource allocations. As the FBI has been working on terrorism now obviously since 2000 -- since the 9/11 attacks, but -- it has to do with system capacity problems, it also has to do with them focusing -- essentially because they didn't have these task forces, which were necessary to

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prosecute higher level frauds, control frauds, during the Savings and Loan Crisis, they partnered with the Mortgage Bankers Association which essentially looks at frauds against lending institutions rather than frauds that might be committed by lending institutions. So that was a major problem for them. It still is.

But of course now we're looking at the effects of this crisis and the rebound frauds that are occurring in the current housing market and just cleaning those up is a major issue for the FBI. So it's really doubtful -- I think it's doubtful that they're going to be attacking the higher level frauds with the kind of energy that they were doing during the Savings and Loan Crisis just because there was a much better system in place at that time. So, again, a system capacity issue brought on by focusing more on the lower level frauds and getting into the prosecution of these frauds a bit later.

COMMISSIONER GRAHAM: Mr. Black, in listing some of the steps towards being an ultra profitable control fraud, you mentioned leverage. That's an issue that's come up in a number of different ways

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in our previous hearings. How were you using the word "leverage" as a component of a good step to ultra profitability?

MR. WILLIAM BLACK: It simply means having very high debt in this context and that levers up your return on equity.

COMMISSIONER GRAHAM: This is high debt in the mortgage originators?

MR. WILLIAM BLACK: This is high debt at the lender institution. But it follows up the food chain. As you know, you can use the SIBs and they did use the SIBs to create leverage ratios that were well beyond anything that lenders had directly. And as you probably already know, the Europeans were even worse, the European banks.

COMMISSIONER GRAHAM: The Chairman, in his open remarks, mentioned the fact that this Commission is the product of federal legislation which had as its title "Mortgage Fraud," indicative of the priority that the Congress was giving to this component of the number of factors that contributed to the financial meltdown.

How effective do you evaluate the steps that the federal government has taken since this crisis began to rein it in and hopefully avoid a repetition?

MR. WILLIAM BLACK: As to the first, wholly ineffective. As to the second, moderately. effective against the particular mechanisms that brought this fraud.

What do I mean by that? The FBI performed brilliantly originally. It realized and testified publicly in September 2004 that there was an epidemic of mortgage fraud and predicted it would cause a financial crisis. I mean, that's as good as it can possibly get.

The FBI did have severe limits. It lost 500 of its white-collar specialists in response to the 9/11 attacks, which we can all understand. Many of us don't understand why their requests to be allowed to replace them was rejected. But that happened. So white-collar prosecutions went down substantially in this time period.

What the terrible thing happened was that the FBI got virtually no assistance from the regulators, the banking regulators and the thrift regulators. Two things are going on in contrast to the savings and loan practice.

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First, roughly 80 percent of liar's loans came from nonregulated entities. All right. These are the mortgage bankers. So the regulators weren't there to make criminal referrals period with regard to that group.

But even as to the 20 percent roughly that came from the federally insured sector, it's just incredible. The Office of Thrift Supervision and the Office of Comptroller Currency, their official spokesperson told the Huffington Post that they made zero criminal referrals. Zero. We made thousands of criminal referrals in the Savings and Loan Crisis.

We as the regulators -- if I could put my old regulator hat on -- we're the Sherpas. All right. We do the heavy lifting and we do the guide function. Because the FBI can't possibly have the expertise in each particular industry. The regulators disappeared and their role instead was filled by the Mortgage Bankers Association which created this absurd supposed all -- you know, gal is divided in three parts. But to them, mortgage fraud is divided into two parts. And in both of them, guess what? They're the victims and their

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CEOs are never criminals.

That's completely contrary to all prior history, Enron, Worldcom. I was the executive staff director for your predecessor commission that looked into the Savings and Loan Crisis. That report says that the typical large failure fraud was invariably present, and they meant at the top of the food chain.

So that hasn't happened. They've looked instead very low in the food chain. When you gut underwriting, as I said, you do get massive fraud. You create probably in the order of 6 million homeowners and 10,000 perhaps, 50,000 perhaps, of the flippers. Maybe a hundred thousand of the flippers. But unless you go at the people at the top, you're never going to be successful in prosecution with the kind of resources they would bring to the task.

COMMISSIONER GRAHAM: Ms. Murren?

COMMISSIONER MURREN: Thank you.

Mr. Black, if I could follow up on your last line of discussion. When you look at corporations, there is clearly a desire and a need for growth going into the future and an ability to demonstrate

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that. So how do you reconcile these two things that seem to have such tension between them which is the desire to grow a company and yet the desire to be able to be responsible, and at what point does it cross the line into having an intention to commit fraud? And I wonder if that's not really why we haven't seen more prosecutions as establishing the intention at a much higher level within the company.

MR. WILLIAM BLACK: Yes. I mean, the issue also is intent. Let me say we got over a thousand priority felony convictions in the savings and loan industry. Those are of elites. There have been zero in this crisis of the specialty -- the people that specialized in makes the liar's loans. The large lenders, zero senior executives.

COMMISSIONER MURREN: And to what do you attribute that difference?

MR. WILLIAM BLACK: Well, if you don't look, you don't find. And they defined -- they literally adopted the definition of mortgage fraud -- you'll see it repeated endlessly -- under which the lender is never the fraud.

And by the lender, let me be more precise.

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It's not of course the institution. It's the individuals. And I repeat, there is no reason why an honest lender would ever do things like inflating an appraisal. More generally, in economics when you make liar's loans, you maximize what we call adverse selection.

COMMISSIONER MURREN: But, Mr. Black, if I could, in today's world where you're not holding it perpetually in a place where you originate the loan but then someone else assumes the risk of the loan, is that true anymore?

MR. WILLIAM BLACK: Absolutely. Remember the emphasis on the word "honest." Because you have to sell it, and these were sold under reps and warranties, all right, that they were honest. And can you imagine a business otherwise? Hello. I make honest liar's loans? It's an oxymoron that didn't exist in the real world.

And if I could just real briefly. This has been forever. Right? This isn't new. We killed liar's loans in 1990 and 1991 as savings and loan regulators, when they were becoming significant in California savings and loans, and there was no crisis. People have forgotten this even existed.

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Why did we do that? Because we knew it created adverse selection. That means definitionally the expected value of making that loan is negative.

So this isn't a matter of growth. I would love my competitor to make bad loans that had a negative expected value. That would be good for me. All right. I don't lose anything by not making a bad loan. So, no, it isn't a pressure for growth by making bad loans. That never existed in the industry. It does exist in the perverse world where it optimizes your fraudulent income.

And, again, this is not just a criminologists' saying. I mean, we're kind of the Rodney Dangerfields. You know? I doubt that many of you ever talked to a white-collar criminologist before this day. But this is Nobel Prize winning economist, George Akerlof, saying, Yes, this is exactly what's happening. And that's disappeared from the discourse.

COMMISSIONER MURREN: Thank you.

Ms. Fulmer, if I could ask you a question. You had referenced in your testimony a national index of property value fraud risk, and I was wondering if you could talk a little bit about what

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that is. Is there a way of measuring how much fraud may be present in the system or monitoring for such fraud, and is that something that was in common use over the course of the last five to ten years or is that a recent evolution?

MS. FULMER: The mortgage fraud risk index that I referred to is an index that we developed at Interthinx.

To answer a step back in one level, it is nearly impossible to measure the incidence of the frauds that's out there because Suspicious Activity Reports are the primary vehicle by which we have the most comprehensive information. Those are filed with the Financial Crimes Enforcement Network, but only about a third of the industry that has any information is required to sell. There is no safe harbor for people like mortgage insurers or title insurers or appraisers or real estate agents who are not regulated financial institutions. They're not protected from voluntarily reporting an incident that they observe.

So having said that, I have to distinguish what Interthinx does. We look at applications as

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they're being submitted by lenders and we evaluate and stratify their risk for fraud, low, medium and high. And the reference I talked to you about, the Property Valuations Fraud Index, is what we looked at for the incidence of those kinds of indicators in the loans that we were scanning at the time going back to up to 2003.

COMMISSIONER MURREN: So what types of flags would be raised in such an analysis? I mean, how would you determine if the property values themselves were inflated if you couldn't do it after the fact? In other words, is there a prospective way to do this analysis or is it retrospective?

MS. FULMER: No, that's exactly what I'm talking it does is we take the application, which includes an appraisal information and value information, and we pull together -- we have a proprietary database. We buy private sales information for states where sales prices are not disclosed. We use automated valuations models, we use multiple listings service data, and we combine all that together. And I got the verbal gene, I don't have the math gene, so I cannot explain the

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mathematics that go into this. But they take all of those factors and they evaluate that, look at sales in the neighborhoods, look for things like the same people selling constantly in the same market, and there's a variety of elements that we look at and compare which was presented to determine whether the value is inflated. We also look at the time lag between the last sale and the proposed sales and the spread between those two prices over time.

COMMISSIONER MURREN: This body of work that's done, is this the type of thing that would be done in the mortgage originator's office or in the bank itself during the course of the crisis? In other words, is this the kind of thing that should have been done and someone was assigned to do it within those institutions, but it was either not carried out or it was not actually mandated for anyone to do?

MS. FULMER: I joined Interthinx in 2005, so I can't really speak to directly what was going on, but I've been told that prior to that time, these fraud detection and prevention tools were primarily deployed by lenders in the post closing environment

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as a quality control tool, which I suppose relates to the fact that they were selling loans to Wall Street and had those reps and warranties with respect to quality and integrity of the loans that they were originating. In 2005, when there started to be a much higher default rate that started to occur in certain segments of the lending market, then lenders began to prioritize using this tool as a prevention, but -- as a means of prevention.

Because the secondary market and Moody's and the other ratings agencies generally only requested that about 10 percent of loans be sampled for quality, the number of loans that are run through these tools tend to be in the minority and it does tend to be a sample. The most effective way I think to prevent fraud would be to run all of these loans, all originations, through these kinds of tools in order to find the ones that are most likely to have the most problems and then really focus the intensive underwriting and most experienced underwriters on dealing with those loans. In my opinion, that would be the best way to find and prevent fraud before the money goes out the door and the bank is hurt and communities are ruined.

COMMISSIONER MURREN: Thank you, Ms. Fulmer.

Mr. Pontell, perhaps you could comment on this particular set of responsibilities that an originator might have or a bank as it relates to fraud within a corporation. Could you talk a little bit about how the underwriting quality and the processes through which these companies evaluated the probabilities of their loans being repaid was either fostered or hindered by the corporate culture.

MR. PONTELL: I think the -- I guess the major point I would make is the ethics in these companies flow from the top down and that the ethical standards will filter down to those below it. The people making these assessments at the lower levels essentially could easily rationalize or neutralize their work because of the support they were getting from the top; that when they were not doing the underwriting -- and, again, the originators, the brokers, the loan processers, the underwriters, the loan reps and the lender companies, the account managers all were able to easily rationalize their behavior against doing what they were supposed to be doing. Essentially evaluating the credit qualities of those loans.

So in terms of corporate culture where you have people at the top who are not adequately training staff or showing staff the way and also creating the incentives for them to produce as much paper as possible, it's going to be very easily neutralized. We have some evidence of that from a recently published study of these folks that were easily rationalizing their behavior.

COMMISSIONER MURREN: Thank you.

COMMISSIONER GRAHAM: Thank you, Ms. Murren.

Mr. Georgiou?

COMMISSIONER GEORGIOU: Thank you very much, Senator Graham.

You know, when I bought my first home in Nevada, I went to Countrywide and I put down 20 percent, borrowed 80 percent, got a fixed fully amortized 15-year loan, and I realized at the time it was a little bit difficult to get to the quote on the loan. I guess it's probably because nobody's ever asked -- nobody ever asked for one and I may be the only one who ever got one out of

Countrywide for all those years as I've learned going through this process.

You know, I think your testimony is exceedingly disturbing to all three of you really with regard to this issue. I've spent a lot of time -- I've spent most of the last decade civilly prosecuting financial and securities fraud at Enron, Worldcom and certain other areas, and one thing I've learned in the course of this Commission is that a lot of the market participants essentially had no financial responsibility for the consequences of their creation at every level of the process from the mortgage originators to the securitizers of the investment banks to the lawyers who wrote up the prospectus as they audited, the credit agencies, and they were all compensated at the front end of the process for creation and with essentially no financial consequence for the failure of those either mortgages themselves or the securities that the mortgage was packaged into; mortgage-backed securities, CDAs, CDOs squared and cubed, synthetic CDOs, and the like.

I don't think I've ever met a white-collar criminologist, Mr. Black, so it's interesting

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that -- I don't know how many of you there are, but I suspect there's not enough for a society to be put together. But I guess I'd really like to focus on this study that all of you have made that really from the top, the responsibility for the whole ethic of the building of this super structure that brought so many institutions down, how we can get at that.

I suppose prosecution is certainly one way. I think the S&L crisis that to the extent that people actually faced criminal prosecution was certainly a deterrent to some extent. But it seems to me that when you create a system in which people don't have to pay for the failure of their own creations and they get compensated fully when they're created, you're creating a system that's essentially doomed to failure.

Let me ask a question, if I could. Ms. Fulmer, you advised mortgage bankers and others, I take it, with your fraud detection work.

Is that right?

MS. FULMER: That's correct.

COMMISSIONER GEORGIOU: Do you find receptivity on the part of your clients getting this information? Just to be candid, I mean, do you think they like to hear it or they'd rather ignore it or they'd rather not hear it and just fund the loans?

MS. FULMER: Well, fortunately the people that I work with directly are the quality control people and the risk management people and they're very receptive and they -- you know, they have been trying very hard to improve quality and to improve process and to reduce the incidence of fraud, especially those who I think have come to understand the effect in communities.

When we first started trying to talk with bankers back in 1996, they were absolutely horrified to find out what was happening at ground zero, because it seemed like fraud didn't happen that much and it was basically an issue for a profit and loss statement and that there was no real victim other than financial. But the people that I work with, yes, are very concerned.

COMMISSIONER GEORGIOU: Well, what's interesting to me, do they ever have a prefunding interview at the final hour or the hour when all the previous work has been done with the borrower?

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Does anyone have a practice of assigning a particular person from the ultimate purchaser of this loan to sit down, for an hour say, with the borrower and confirm their tax returns that are in the file, confirm their employment, confirm that they're going to live in the home, confirm that they're actually a qualified borrower?

Maybe we ought to try to incentivize people by making that ultimate person who is the last step before funding responsible for the failure of the loan in some way. Maybe their pay gets docked in the future if that particular loan defaults.

MS. FULMER: I do not know of any banks that do that directly; however, that is theoretically part of the responsibilities of the closing settlement or escrow agent is to verify that the this information contained in the application, which would include things like intent to occupy, value, borrower's income and things like that, at the closing table.

Unfortunately, settlement agents don't always see it that way. Some of them misunderstand some of the consumer financial protection laws as prohibiting them from even asking about that information, and others who are at the closing table are collaborators or corrupt.

COMMISSIONER GEORGIOU: But, you know, we all have this great image, you know, of the local thrift and loan that was immortalized in, you know, the Christmas movie that we always watch about somebody who actually knows their borrower only lends to them with the expectation that they'll actually pay it back and so forth, which obviously bears the financial consequences of the failure of that loan would pay a great deal of attention to.

I'm just wondering what it is that we can do as a society on a go-forward basis to try to create market mechanisms to enforce this kind of discipline on a go-forward basis.

Mr. Black, do you have any thoughts in that regard?

MR. WILLIAM BLACK: I have a number of specific suggestions in my written testimony, but directly apropos to what you've asked, here are the two most obvious.

First, executive compensation is based overwhelmingly on short-term reported accounting gains, and since the crisis, the percentage of executive compensation based on short-term has increased instead of decreased. Now, that's insane and everybody knows that's insane; that it creates the worst possible perverse incentives. So change that.

Similarly, compensation is used to suborn professionals. Right. They were always able to get a clean opinion from a top-floor audit firm. They were always able to get Triple A from a top-three rating agency for stuff that wasn't even Single C. They were always able to get an appraisal that was in many cases inflated literally a hundred percent in terms of value.

So you have to deal with compensation of professionals as well. One of the best things to do there, I suggest for your consideration, is take the hiring decision away. In other words, we assign the credit rating agency to you. You don't get to pick them. You don't get to put them into competition. And then we look and see how successful are you as a credit rating agency. If you're successful, great. If you're a failure, we yank your designation. And allow competition in the rating industry context or the auditor context.

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Appraisers, for example, we've known how to do the appraisals right for 150 years, which is we don't leak to them what the loan amount is, which is done pervasively in this industry. And we hire them and we don't put them on a bonus system based upon volume but on the quality of the loans. You do that and you'll create the right incentive.

So we're all with you. You have to change the incentive structures. That's the message from white-collar criminologist, from economists, from competent regulators. And unless and until we do that, we're going to have recurrent crises and they're going to get worse.

COMMISSIONER GEORGIOU: I mean, I'm struck by this notion that you -- obviously a lending institution should have no incentive to make a loan that they think is highly likely to fail, to be not paid back, unless they have no ultimate consequence. And we've seen not only are the individual parties within the system not bearing the consequences of their creations when they file, but even the institutions themselves, because they've become for the most part too good to fail and were ultimate bailed out by the taxpayers, even

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the institutions that didn't -- that didn't bear the consequences. So we've created a system that basically lacks accountability and market discipline at every level in the process.

MR. WILLIAM BLACK: Private market discipline becomes perverse in the presence of accounting fraud. The market -- and this, again, is Akerlof in his Nobel Prize winning article refers to it as the "Gresham's Dynamic". Gresham's Dynamic is when bad ethics creates a competitive advantage. Bad ethics will drive good ethics out the marketplace.

Two really brief examples from part of life to show you how severe this can be. Infant formula in China. It's cheaper to put water than milk. China looks for that, so they put melamine in to spoof the protein test. Now you have something that has no nutritional value for the part of the population that most desperately needs nutrition and has contaminant that kills six kids and hospitalizes $300,000 infants and drives every honest manufacturer of milk product out of business in China for about nine months.

And of course the other one here in Florida that's famous is Chinese drywall.

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COMMISSIONER GEORGIOU: Right.

Mr. Pontell, do you have any thoughts?

MR. PONTELL: No, I would essentially agree with what you've got, Commissioner.

And I would also just say briefly in support of Professor Black's comments that I think it's very important to be able to relate -- to correctly relate historically the nature of fraud in these crises, and what we've seen in past crises is fraud that exists in major institutions. And that's necessary to do. Because if it's whitewashed or not taken seriously, we're going to essentially, as you correctly point out, if you review these crises, as it turns out historically, we leave them in greater and greater magnitude as time goes on.

So it's important from a preventative stance to have effective regulations that understand the nature of these types of frauds. And not just the low-level frauds, but the higher level frauds which derive a lot of the low-level frauds which inflate bubbles and cause massive financial losses.

And then of course once you do have those regulations that fully account for this type of fraud, you need to have regulation. You need to

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have enforcement. Having the laws on the books is one thing, but from what we've seen in the current crisis is that there was -- as Professor Black correctly pointed out, there's essentially an absence of enforcement regulators who essentially did not believe in regulation. And so you have massive failure because no one was essentially looking.

CHAIRMAN GEORGIOU: Thank you very much.

COMMISSIONER GRAHAM: Ladies and gentlemen, I apologize, but we are going to have to take a short break at this time. I'm asking if everyone could stay in their seats. Apparently there has been some problem with the audio for the web streaming that is being used to communicate this hearing. So if we could take a short break to get that problem fixed and then we will reconvene with Vice Chairman Thomas asking questions.

COMMISSIONER GERGIOU: Does that mean all my questions disappeared into thin air?

MR. WILLIAM BLACK: Not for lip readers.

CHAIRMAN ANGELIDES: There was an 18-minute gap.

(Break taken.)

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COMMISSIONER GRAHAM: Ladies and gentlemen, our problem has been corrected and we will continue. Let me use this as an opportunity to ask of our witnesses, your testimony has been very fulsome and has raised many questions beyond those that we are going to be able to ask in the limited time we have. Would you be willing, if we submit written questions, to give us your written response? Thank you very much. We appreciate that, and those will be part of our official records as your comments are here this morning.

VICE CHAIRMAN THOMAS: Did I see Mr. Black's head nodding?

MR. WILLIAM BLACK: Absolutely.

COMMISSIONER GRAHAM: And he isn't in Missouri.

CHAIRMAN ANGELIDES: I knew this.

COMMISSIONER GRAHAM: All right, Chairman.

VICE CHAIRMAN THOMAS: Thank you very much, Senator.

Just to kind of get a flavor of what's going on, clearly what we would call criminal activity -- and I think to a certainly extent some of the stuff that maybe went on didn't quite reach the criminal

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level, although if folks fixed their attention and examined the full scope of the behavior, it would.

This is a question that any of you can answer, and I guess we can start with Ms. Fulmer and go across. So we have this criminal activity and I'm trying to get a profile. Because although clearly Medicare fraud in terms of the total amount in that short period of time was not the same as the mortgage fraud. The ongoing criminal aspects, hopefully blunted as we begin to get some regulations, to me is very similar; and that is when your chances of getting caught are absolutely minimal and that once you see what's going on, it's not that difficult to pick up the scam and then more and more people do it.

Did we see from any of your investigation or any of your knowledge in terms of professors that criminals moved into this area? Now we like to think they would have to take a real estate exam or some other kind of credentials to participate in this area or require some ability and training. Was it homegrown in terms of virtually nothing but the incentives and the compensation system of those who are already in the system or did you see movement of individuals

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who see an opportunity to carry out scams moving into the mortgage area? Any evidence one way or the other?

MS. FULMER: Commissioner, what I've seen is primarily people who have moved -- either who did not have a criminal background at all and get sucked into things by a perpetrator --

VICE CHAIRMAN THOMAS: Sucked into things?

MS. FULMER: I mean, one of the favorite terms during the boom, there's a misperception that loans -- primarily that this was concentrated in subprimes. And at the end, clearly with all the limited documentation loans and very risky borrowers, that was true. But in the beginning, the prime borrowers were one of the primary targets of perpetrators used through realty investment clubs, through investment seminars, free seminars at the hotels, looked for inexperienced people with good credit ratings who were prime borrowers to act as their straw buyers. They promise, you know, these incredible returns and no money down, cash back at closing. We'll manage everything for you. All you have to do is collect a check at the end of the month.

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In addition to that, there have been a lot of instances -- well, actually the first guy that was operating in my neighborhood that was arrested on mortgage fraud charges had been convicted several years earlier in California on intent to -- possession with intent to distribute within a school zone, and he reportedly had banked his illicit drug trafficking profits to start him up in mortgage fraud.

And there were clearly -- there was a woman who also was operating in my neighborhood who went to jail who continued in Atlanta and she went to the Marianna Prison down here in Florida. She continued to run her operation from her jail cell and was recruiting people who were about to be released to go in and act as fraud.

A lot of times too these straw borrowers who learned how to do it, they would go off and start their own ring. So it was sort of like a hydrant. You chopped the head off one ring and there would be several more that would spring up to take its place.

VICE CHAIRMAN THOMAS: And that was here in Florida?

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MS. FULMER: Yes.

And often in Florida, before I forget --

VICE CHAIRMAN THOMAS: I assume there will be a Carol Hiaasen novel.

MS. FULMER: I'm sure there will be.

And I would be remiss to also recognize that -- and this is my written testimony -- that I think it was the Miami Herald did a survey, did a study, and they found out that there were 5,000-something mortgage brokers and another 5,000-something loan originators who were not regulated but who had criminal felony convictions which included bank fraud and other types of fraud who were originating during the boom.

VICE CHAIRMAN THOMAS: Professor Black?

MR. WILLIAM BLACK: You're right to focus on entry, vias of entry. That's a major factor in why you see these crises being so lumpy. And so in the Savings and Loan Crisis, it was easiest to enter in Texas and California and they had the weakest regulation, the broadest asset powers. Something like 70 percent of the total losses came from those two states in that crisis. There was a Texas-rent-a-bank scandal before the Savings and

Loan Crisis, and those that were not convicted in that showed up again in the savings and loan debacle.

You're quite right about the Miami Herald piece that found thousands of frauds, and it was because entry was so easy as a broker. It's very easy to enter as an appraiser as well. And in the past, it was -- there were virtually no barriers to entry. Wherever you have very easy entry, you're going to allow a very swift run-up in fraud. Because, you know, in any particular industry, maybe there are 5 percent sleaze-oids. But if it's really easy to enter, then you can get an enormous influx. And we had hundreds of real estate developers, for example, suddenly get new charters for savings and loans, because of course it's a perfect conflict of interest. So you're on exactly the right theme.

MR. PONTELL: And I would essentially agree with that. During the Savings and Loan Crisis, as history shows, the lack of regulations in Texas to California created such a vacuum that it literally, to use the word, sucked in a bunch of unsavory business characters. It also allowed legitimate

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folks to get into the industry as well with no prior experience and saw the opportunity to make great profits and they did so many times illegitimately.

VICE CHAIRMAN THOMAS: It just seems to me oftentimes that we're on the other side of looking at the devastation of, quote/unquote, white-collar crime as opposed to some kind of violent crime. And you indicated, Professor Black, that the FBI shifted its resources.

I just have to tell you that in my community, there have been several people who have, I assume, jokingly approached me in terms of being frustrated in trying to get authorities and others to look at what's happened to neighborhoods and communities that have empty houses that get vandalized and the damage that has done and suggested, again I assume not seriously, that if they went around and bombed a few of them, that they would get the legal and community focus on exactly what was going on.

Is there still this -- when you watch any movie or television show, oftentimes the white-collar criminal is kind of a clever, cavalier kind of a person, kind of fun, because there's no real victims to it.

Is this an attitude that you've seen when you talk, for example, Ms. Fulmer, with the people that you indicated are the ones who are in a position to do something about this; that there just doesn't seem to be the urgency that other kinds of criminal activity create in people?

MS. FULMER: Absolutely.

When I first put together the chart showing these illegal transactions in my neighborhood and myself and other members of the community association went to the U.S. Attorney's Office, he -- Look. I mean, it was crude at the time, but it had addresses. It had names underneath. It showed how all these houses were all in these transactions and they were all combined together. And the U.S. attorney looked at me and said, Is that all you have? I don't think we need -- you know, we don't need to have any kind of task force here. And he didn't come out and say it, but he essentially implied that I was a pretty bored housewife and I should get a better hobby.

He then did in fact open a case which sat on the desks of a U.S. -- an Assistant U.S. Attorney

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for two years with little to no prosecution, and it wasn't until I had submitted a letter to then Governor Barnes on behalf of 15 neighborhoods that had been severely impacted by fraud and had put that also in the records with the U.S. Attorney's Office. The new Assistant U.S. Attorney named Gail McKenzie saw it and realized that there were real victims; that it wasn't just financial crime.

Unfortunately, now it's even worse because there are so many reported cases that it is my understanding that U.S. Attorney's Offices throughout the country have developed an informal threshold where they will not look at a case unless the aggregated damage to the lender is a million dollars. And of course since the FBI is not going to waste its resources looking at cases that aren't going to get prosecuted, they don't get prosecuted.

VICE CHAIRMAN THOMAS: We heard some of that testimony in Las Vegas along the same lines that unfortunately as you accumulate, quote/unquote, smaller amounts, the end amount is enormous, but the incidental aspect is very small.

Last questions over to the professor.

As you indicated, these loans carry with them

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some responsibility as to the viability of the loan. And you had mentioned, and it's quite true, that Freddie and Fannie are holding a significant percentage of these loans. I saw in a news story that Freddie and Fannie are now thinking about taking action, going back to the sellers to try to recoup.

Don't you think that would be one way at reversing this compensation with no downside and creating an awareness of the consequences? Or is it liable to go the usual direction, since after all it's only the taxpayers who are left holding the bag, it doesn't create that threshold of being intensely focusing on the individuals who were at the front of that food chain, notwithstanding the fact the Freddie and Fannie were the buyers?

MR. WILLIAM BLACK: Well, the proof is going to be in the pudding, right? Because --

VICE CHAIRMAN THOMAS: It always is. There are very few pudding parties in Washington.

MR. WILLIAM BLACK: Your Commission has gotten some of the key testimony. I think it was a Mr. Bowen, the CitiCorp. individual who said that 80 percent of what CitiCorp. sold was under false reps and warranties and that it sold primarily to Fannie and Freddie, and then if I recall the testimony, that they sold roughly 50 billion a year. Well, is our Fannie and Freddie going to put that stuff back to Citi?

VICE CHAIRMAN THOMAS: As they say, do the math.

MR. WILLIAM BLACK: Exactly. That's why I don't think it's going to happen.

VICE CHAIRMAN THOMAS: Yeah, and that concerns me.

Last question, and not for your response now, but in a written response as we go forward, given your knowledge, involvement, especially the historical perspective across the landscape, the new law that's passed in terms of potential rates, any hope -- is this going to create the awareness and responsibilities in the officials who are charged with these duties versus where we've been recently?

That's not for response, but in a written form to the Commission. Thank you very much.

CHAIRMAN ANGELIDES: Mr. Chairman, thank you. Excellent testimony.

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Folks, thank you very much.

Some very quick questions here. I want to get to it to an extent. But before I do, I just want to be clear here essentially what I hear both of you saying -- and I'll ask you, Ms. Fulmer -- is that at the very least, the lending organizations themselves created the climate in which rampant fraud can exist at the minimum.

At the other end of the spectrum they actually, as you would say, were perpetrating controlled fraud by the nature of the system they had set up. But at the very minimum, you would say they created the environment in which this fraud can run rampant. Correct?

MR. WILLIAM BLACK: Yes, they're necessary in the logic sense of the word.

CHAIRMAN ANGELIDES: And, Ms. Fulmer, do you agree with this?

MS. FULMER: Yes, but with a qualification.

I think that part of the reason this happened was because originators were making loan products that were designed to sell in the secondary market. The secondary market was being told -- well, all the lenders actually being told, especially around

2002, 2003, that people needed -- that everyone needed to own home because it was the surest way to wealth and were pushing lenders to make loans to increasingly risky borrowers. So I think -- and consumers at the same time wanted instant answers. They wanted a loan right now. They didn't want to have to pay a whole lot for it.

So to some extent, there was certainly market pressures and there were also government policy pressures that led the secondary market to say, Well, we can't meet any of these demands unless we lower the standards, and that was in fact in response to both government and market demand.

CHAIRMAN ANGELIDES: Let me ask you, would you all agree that liar's loans is where this all happened? Was this the center of this; the elimination of documentation in term of income and assets? It was the big door that opened?

MR. WILLIAM BLACK: It was the biggest single, but there were multiple doors, including commercial real estate, which we haven't talked about at all, where very similar processes occurred.

CHAIRMAN ANGELIDES: But in the residential sector, it was the biggest door that opened was the elimination of documentation?

MS. FULMER: It exploded, but it was epidemic in 2004 before that really took off. I mean, like I said, flipping started in 1996 and it was huge back then.

CHAIRMAN ANGELIDES: And, Mr. Black, let me ask you a question. Because I guess it was either your testimony or Dr. Pontell's testimony where it said that, you know, 80 percent -- I think the FBI noted that 80 percent of the fraud required some inside participation. Was that --

Whose testimony was that?

MR. WILLIAM BLACK: It's certainly in mine.

CHAIRMAN ANGELIDES: All right. So to what extent -- and I know it's case by case -- but what is the line, just to probe what Ms. Murren was asking, between recklessness and criminality in the organizations who are creating these products that end up being fraudulent products?

MR. WILLIAM BLACK: Well, the key is you have to look to know. And because the regulators have been out of regulating, we've looked at about eight places now. We've looked at New Century. You can look at the examination report. That is completely consistent with what I went through and how you optimize control fraud. The Senate has looked at WaMu. That is completely consistent with how you optimize a control fraud. We've looked a little bit at Aurora, the liar's loan outfit of Lehman Brothers.

CHAIRMAN ANGELIDES: When you say we --

MR. WILLIAM BLACK: That is the bankruptcy examiner. I mean as a system.

CHAIRMAN ANGELIDES: All right.

MR. WILLIAM BLACK: I looked because I testified about that in front of the House.

We've looked -- you've looked at CitiCorp and you had this 80 percent number. Countrywide, we have civil investigations that have led to the release of facts that, again, say they knew at the top about the quality of the product. So --

CHAIRMAN ANGELIDES: So your basic point, I understand, is that you will not understand that line between recklessness and criminality unless you look at the particulars and what executives knew and why they allowed the products to move into the marketplace?

MR. WILLIAM BLACK: Correct. But liar's loans

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I think you're going to find every executive has known for centuries lead to adverse selection and negative expected value of a transaction.

CHAIRMAN ANGELIDES: All right. I want to ask you a question about extent and impact. In your testimony I think, Mr. Black, or Dr. Black, whatever you go by, I think you did some quick math and said, Well, there's 63,000 SARS. I can't remember what year that was, but, you know, obviously at a peak year, 2007, 2008. You know, per the mutual testimony here, you said 80 percent of the lenders were not covered by that reporting requirement.

You said two-thirds. Let's just take the two-thirds for minute. That would -- if you say that -- you multiply the 63,000 by 3, you get 189,000 loans in one year where, had you had full reporting, you would have gotten SARs.

And then I think you cited, Mr. Black, a New York Times story that said that someone indicated that the FBI had only about 20 percent of the loans with fraud were detected as having fraud at the front end.

MR. WILLIAM BLACK: That's correct.

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CHAIRMAN ANGELIDES: So you'd come up to about $845,000 loans a year by that math. Not insubstantial.

Our own staff did some quick calculations, which I asked them for, where I guess in 2009, if you look at half a year, there's $1.6 billion in losses from SARs. If you make that a full year, it's 3.2. If you times that by 3 to account for all the non-reporting entities, you get up to about 9.6 billion in losses. But even then, only about 7 percent of the SARs name a loss figure. So taking that into account, you'd come up with annual losses of 137 billion.

I'm going to stop there. A couple more things, Mr. Vice Chairman. Apparently the person at Fannie in charge of mortgage fraud has indicated that their review of loan files from 2006 to 2008 indicate fraud in 70 percent of the files. It makes you wonder, by the way, Mr. Vice Chairman, why didn't they check before they bought versus now?

But my question for you is what's the extent of this? Are talking about a 5 percent problem? Are we talking about a 10 percent problem? Are we talking about a 30 percent problem? What's the dollar magnitude if you have any date on this? I know it's a long question, but I think it's central to our inquiry about causes.

And I'll start with you, Mr. Black, and Ms. Fulmer, and to you, Dr. Pontell.

MR. WILLIAM BLACK: So to take your extrapolation, the thing you have to add to it is it's fine to extrapolate from SARs if when they find --

CHAIRMAN ANGELIDES: And by the way, for the audience, SARs, Suspicious Activity Reports, are required to be filed by only certain financial institutions when they see -- when they suspect financial crime.

MR. WILLIAM BLACK: Right.

But we know from the lumpiness of SARs reporting that overwhelmingly insured institutions which have a duty to report aren't reporting even when they find fraud. Now, that should be intensely suspicious. They should go to the absolute top of the list. All right. So you have to add that into your extrapolation.

When you do that, you get exactly what we get when we look at it from the other direction. You take the number of liar's loans and you can take the incidents of fraud in those liar's loans, and you get in the range of at least a million and-a-half per year during these peak years.

CHAIRMAN ANGELIDES: A million and-a-half loans that have some form of fraud in them?

MR. WILLIAM BLACK: That have some sort of fraud, that is correct.

Now, what you then do, that means that you have just right shifted the demand curve enormously for those of you who have an economics background. The marginal buyer was the liar's loan, and that means you made the bubble a lot worse as well.

And now the next point is you can deal with your economist and they will tell you about at that point we don't know whether losses are linear in jargon or not. In other words, a 5 percent increased bubble could produce a 20 percent increase in losses or 3 percent. But more likely the 20 is what I think your economists are going to say.

If you take into account the bubble effect, then you start talking about numbers not of

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$150 billion a year, which is about what you get from this at an absolute minimum, but you start talking in terms of trillions of dollars of market value losses.

CHAIRMAN ANGELIDES: Do me a favor -- I'm going to go to Ms. Fulmer -- would you in response to the Chairman's question, would you provide us --

MR. WILLIAM BLACK: Take that as a written request.

CHAIRMAN ANGELIDES: Yes, on this one item of extent of impact.

MR. WILLIAM BLACK: Yes.

CHAIRMAN ANGELIDES: Ms. Fulmer, extent of impact.

MS. FULMER: It is incredibly difficult for all those reasons to articulate on any kind of a number, but Interthinx has been doing audits in a context of the purchase demands and defaulted loans and our analyst in San Francisco estimates that based on a random sample, of the loans originated between 2005 and 2007, he estimated that 13 percent of all originations contain fraud which would be a market value of -- there were 37 million loans taken during the time and about $8 trillion so that

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approximately $1 trillion worth of originations he says are proven fraud.

If you talk to lenders, it depends on what kinds of loan product that they were originating and more when it was originated, but --

CHAIRMAN ANGELIDES: What were those years again, the years again for your --

MS. FULMER: 2005 to 2007.

CHAIRMAN ANGELIDES: 2005 to 2007.

MS. FULMER: But when you're ball parking and you're at a quality control meeting or an MBA fraud issues meeting and you're talking with people who are in the front line looking at these things every day, they estimate that as much as 60 percent of loans originated, which would represent 4.8 trillion in market value, were fraud at the origination between 2005 and 2007.

CHAIRMAN ANGELIDES: And that's from people who are in the field?

MS. FULMER: That's correct.

If I might go on just a bit little farther --

CHAIRMAN ANGELIDES: Yes, keep going.

MS. FULMER: Based on what we've seen in the loans that we are auditing, approximately --

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CHAIRMAN ANGELIDES: And you're auditing these on behalf of purchasers who are now putting them back?

MS. FULMER: Correct.

CHAIRMAN ANGELIDES: Okay. For purposes of reps and warranties.

MS. FULMER: Or looking to see, you know, if they can defend against or refer this for fraud.

CHAIRMAN ANGELIDES: Oh, okay. So you're doing analysis on both ends?

MS. FULMER: Yes.

And when you talk about loans that were foreclosed, have actually gone into foreclosure, the conservative, the very conservative estimate is 16 percent of the loans that went into foreclosure contain fraud at origination and that's about $170 billion worth of loans. The maximum again around --

CHAIRMAN ANGELIDES: Again, in the 2005 to 2007 --

MS. FULMER: Correct.

CHAIRMAN ANGELIDES: -- period?

MS. FULMER: Correct.

And the maximum sort of

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around-the-water-cooler estimation is about 70 which represents about 2.9 trillion in the loss severities.

CHAIRMAN ANGELIDES: Again, around the water cooler, it's 70 percent of those in foreclosure?

MS. FULMER: Yes.

CHAIRMAN ANGELIDES: Okay.

MS. FULMER: And then if you look at the loss severity, which is the amount a bank actually loses based on, you know, the original loan amount versus what they can recover through insurance -- and, by the way, there is no insurance for identified fraud or for selling the house out of foreclosure -- range from 40 percent to 70 percent of the original loan amount, which for that 2005 to 2007 origination spread would be 68 million to 119 billion roughly.

CHAIRMAN ANGELIDES: Stunning.

Also in response to a written interrogatory, could you provide us an answer --

MS. FULMER: Sure.

CHAIRMAN ANGELIDES: -- and in a sense amplify on what you've written here.

Dr. Pontell, I know I'm over my time, severely over my time.

MR. PONTELL: I don't have much to add. I don't have any particular numbers for you other than to say --

CHAIRMAN ANGELIDES: To spare me the ire of the Chairman, I have many more questions, but the magnitude is what I'm -- the magnitude and the breadth is what I'm really seeking.

Thank you.

COMMISSIONER GRAHAM: Thank you very much, Mr. Chairman.

I want to thank each of the members of this panel. I had high expectations of what we would learn, and you have exceeded those expectations. You have probably, because you've done that, called upon yourself to be asked for considerable written responses to further questions.

MR. WILLIAM BLACK: No good deed.

COMMISSIONER GRAHAM: No good deed goes unpunished and I appreciate your willingness to do so.

We are now about 20 minutes behind schedule, but we are going to take a short, and I would say a seven-minute, bathroom break. We will reconvene

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here at 11:00.

(Recess taken.)

SESSION 2

COMMISSIONER GRAHAM: The Commission will return to order. I would like to thank those who have agreed to participate in our second session which is uncovering mortgage fraud. It says in Miami. If you wish to go outside of that, to Florida and nationally, you're encouraged to do so.

Let me first introduce the members of this panel. First, Mr. Dennis J. Black, President of the D.J. Black & Company. Second is Mr. Edward Gallagher, Captain and Executive Officer of the Economic Crimes Bureau for Miami-Dade Police Department. Mr. Jack Rubin, Chief Underwriter of JP Morgan Chase & Company, and I believe Mr. Rubin is going to be focusing probably particularly on the national issue. And Ms. Ellen Wilcox, Special Agent, Florida Department of Law Enforcement.

I thank each of you for being here, and as we did with our first panel and as we have done with all panels during this Commission's activities, I'm going to ask you to rise and be sworn.

Please raise your right hand.

Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MR. BLACK: I do.

MR. GALLAGHER: I do.

MR. RUBIN: I do.

MS. WILCOX: I do.

(witnesses sworn)

COMMISSIONER GRAHAM: All right. I asked of the previous panel a question that I will ask of you. I anticipate that the information that you're going to provide will raise more questions than we are able to ask verbally during this session and, therefore, I would request your willingness to respond to written questions in areas that we are unable to fully cover this morning.

Would you be willing to do so?

ALL WITNESSES: Yes.

COMMISSIONER GRAHAM: Thank you very much.

Mr. Black?

MR. DENNIS BLACK: Yes.

I will be speaking about appraisal fraud. One of the things I'm going to start out with, I'm going to use the term "USPAP". For those of you not familiar with that, the --

COMMISSIONER MURREN: Mr. Black, would you pull -- yes. Thank you.

MR. DENNIS BLACK: Is that better?

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COMMISSIONER GRAHAM: Yes.

MR. DENNIS BLACK: We use the term "USPAP" instead of the "Uniform Standards Professional Appraisal Practice". And I want to start out by pointing out that the Uniform Standards requires an appraiser to be independent, impartial and objective, and essentially that has been the crux of the appraisal fraud problem. Appraisers who refuse to be team players, who would not hit the numbers for originators, would find themselves not receiving repeat business. There have been untold stories of lender pressure against appraisers. And this is not something that appraisers have been silent about.

In late 2000, a petition was begun signed, by the time it was closed, by 11,000 appraisers pointing out that they were being pressured to inflate values and no repeat business would be coming if they did not comply. That petition was sent not only to Ben Henson, who at that time was the Chairman of the Appraisal Subcommittee, but it also was sent out to many members of Congress and the news media leading up to the time they closed that petition in 2007 for signatures.

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So certainly the appraisal world, aside from the professional organizations, independent appraisers have been screaming the Clarion Call that those who were not acting independently, partially and objectively quite often were pushed aside for those who would be team players and make the deal move forward.

It is important to keep in mind, because in order for a lot of mortgage fraud to move forward, it also required appraisal fraud and it also compounded the problem. So even if you had a situation where you had a borrower who is not committing mortgage fraud, there may have been appraisal fraud involved and there was an inaccurate valuation of the collateral.

And this was talked about by Commissioner Georgiou in the prior session about the movie of It's a Wonderful Life and knowing your borrower. But in the world of what I was using the term "financial hot potato," if you're not the holder of this note, it doesn't become your problem.

So consequently gone are the days where the lender would be very diligent in their selection of an appraiser, because diligent appraisers did not

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move the financial hot potato forward. So, unfortunately, as an appraiser profession, we have seen many of the honest, hardworking, competent appraisers leave the profession because they're not the ones getting the work.

A lot of this was also evident for anyone who wanted to look. If my 30 years of being an appraiser, it has always amazed me the few times that I have been contacted by lending institutions about straightforward quality control work. And the prior session talked about those issues. If you're not looking, you're not going to find any.

And in situations where appraisals come to me now for review, it is not uncommon for 70 or 80 percent of them to be easily identified as being inaccurate, incompetent or unethically prepared. And it doesn't take sometimes 15, 20 minutes to realize that. A little quick looking, using the tools that are available to us, will show us a wealth of information.

I have provided in my written testimony eleven examples of cases that I can speak about with -- well, all first-hand knowledge, but in some I cannot give you entire details because they are

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still pending cases. But I want to talk about --

Example one, there was a condominium complex in Orlando where the developer was promising also sorts of things, such as two years' worth of rent, no homeowners' association fees, and things like that, and consequently today's sale became tomorrow's bad comparable and the appraisers were not doing any due diligence, would not bring that information forward. So it just compounds itself.

Another interesting case was the case that has now been settled where a banker pled guilty to fraud. That is the failure of Coast Bank of Florida in Bradenton. Being that case, the property that he pled guilty to, the appraisal was on a -- the subject was a 10,000 square foot residential lot that looked into somebody else's kitchen and the comparables came from -- in a D-restricted community with a golf course behind the house and lakes and all sorts of things like that. It was apparent, despite an aerial photograph, these are not comparable. If you had just gone looking, it was all there.

And I see the red light is on, so I could give you more example after more example of the same thing;

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just no due diligence being performed or just hiding it.

COMMISSIONER GRAHAM: Thank you very much, Mr. Black. And I'm certain you're going to have a chance to elaborate once we get into the questioning period.

Next Mr. Edward Gallagher.

MR. GALLAGHER: Mr. Chairman, distinguished members of the committee, I'm Captain Edward Gallagher of the Miami-Dade Police Department and Economics Crimes Bureau. I have a statement here.

The Miami-Dade Police Department has always actively handled mortgage fraud cases even before it became endemic. Mortgage fraud cases were received and investigated by Miami-Dade Police Department Economic Crimes Bureau of investigators whenever they were reported. Such cases were prosecuted under the State of Florida grand theft statute.

However, from 2006, Economic Crimes Investigators realized that reports of mortgage fraud were on the rise. Economic Crimes Bureau personnel kept an eye on the emerging trend and consulted with other law enforcement agencies to determine if they had noticed a similar increase in

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reports of mortgage fraud within their jurisdictions. Much to their surprise, they discovered a trend that appeared to be nationwide in scope.

Upon discussing the trend with law enforcement from the State of Florida in 2007, ECB personnel learn -- Economic Crimes Bureau -- personnel learned that they had instituted a new state law targeting mortgage fraud in an effort to contain the growing trend. Economic Crimes Bureau personnel obtained a copy of the Georgia statute and presented it to the Office of Mayor Carlos Alvarez with a request to champion the creation of a similar statute in the State of Florida.

Subsequently, the 2007 session of the Florida Legislature adopted and passed Florida Statute Section 817.545, Mortgage Fraud. The Governor signed the bill into law which became effective October 1, 2007. The Mortgage Fraud Statute created a felony of the third degree for mortgage fraud and provides that a person commits the offense of mortgage fraud if, with the intent to defraud, the person knowingly makes any material misstatement, misrepresentation, or omission during

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the mortgage lending process with the intention that the information will be relied upon by a party in the mortgage lending process; uses or facilitates the use of any material misstatement, misrepresentation, or omission during the mortgage lending process with the intention that the information will be relied upon by a party in the mortgage lending process; receives any proceeds or any other funds in connection with the mortgage lending process that the person knew resulted from such misstatement, misrepresentation, or omission; files with the clerk of the court for any county in Florida a document involved in the mortgage lending process which contains a material misstatement, misrepresentation, or omission.

The law also provides that any mortgage fraud violation is considered to have been committed in a county in which the real property is located or in any county in which a material act was performed.

Concurrently, the Miami-Dade Police Department Command Staff were briefed on the alarming increase in mortgage fraud reports that were being received at the Economic Crimes Bureau in 2007. The Police Department Command Staff and Mayor Carlos Alvarez

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reacted by creating the Mortgage Fraud Task Force. The Mortgage Fraud Task Force is a public/private partnership created to reduce mortgage fraud and prevent victimization of individuals and businesses through effective education, legislation, regulation, law enforcement and prosecution.

The Task Force consists of an executive board that is responsible for policy, decision-making, vision and direction. The executive board consisted of political figures, public sector leaders, business leaders, law enforcement professionals, and prosecutors.

The Task Force has five separate committees. Each committee is responsible for an important portion of the Mortgage Fraud Task Force Commission.

The first one: The Law Enforcement Committee is responsible for the detection, investigation, apprehension and prosecution of mortgage fraud subjects and enterprises.

The Legislative Committee is responsible for enhancing current laws, creating new laws and ordinances. All these efforts are in furtherance of the Task Force mission.

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The Regulatory Committee is responsible for enhancing and enforcing regulations on all parties involved in the mortgage transaction.

The Business Partnership Committee is responsible for the creation and transmission of effective business practices to enhance cooperation with law enforcement and the various professionals involved in the mortgage transaction. The Committee is comprised of banks, title insurance companies, realtors, appraisers and mortgage brokers.

The Education Committee is responsible for creating public awareness through printed literature, newspaper articles, and television reports. The committee is championed by elected officials and media representative.

The Mortgage Fraud Task Force is one of only a few created throughout the United States. However, the uniqueness of this Task Force is the public/private partnership that is fostered. The mortgage fraud epidemic cannot be solved by law enforcement alone. A concerted global effort to attack mortgage fraud on all levels must be undertaken. The Mortgage Fraud Task Force changed the way business is done, prevents those who have defrauded from ever being able to do so again, educates the public to prevent victimization, and swiftly arrests and prosecutes violators of mortgage fraud.

On the law enforcement side, Miami-Dade Police Department assigned 18 law enforcement personnel to the newly created Mortgage Fraud Task Force.

And I see I'm running out of time. But essentially we have created a task force to address mortgage fraud and we have reported a number of resources to address it.

COMMISSIONER GRAHAM: Thank you very much, Mr. Gallagher.

Mr. Rubin?

MR. RUBIN: Senator Graham, thank you for the opportunity to appear here today.

Chairman Angelides, Vice Chairman Thomas, and Members of the Commission, my name is Jack Rubin. I'm a Senior Vice President and Chief Underwriter supporting Chase Home's Lending Division. I joined Chase Bank back in 1983. During my 26-plus years at the firm, I've worked in a variety positions in the mortgage origination business and have held management positions in underwriting and operations.

I understand that the Commission has asked me to address primarily JP Morgan Chase's efforts to discover and impede mortgage fraud. As part of its focus on risk management, JP Morgan Chase commits significant resources in the form of people, training, tools and technology to the detection and prevention of mortgage fraud.

For example, in 2006, JP Morgan Chase hired a senior fraud manager to expand the Fraud Operations Department and bring in mortgage fraud expertise. As JP Morgan strives to mitigate risk in the mortgage loan origination process, it also makes changes and improvements to its programs, products and processes.

For example, in September 2007, the firm eliminated the so-called no-doc and no-ratio loans, and in the first half of 2008, eliminated all stated-income and asset-loan products, which has assisted JP Morgan Chase in curtailing mortgage fraud.

As these examples show, JP Morgan Chase has recognized the critical importance of effective risk management in mortgage originations, consistently devoting substantial resources to mortgage fraud detection and prevention and setting a tone at the very top of the firm that encourages prudent risk management across JP Morgan Chase, including its Home Lending Division.

I look forward to providing the Commission with additional details regarding JP Morgan Chase's mortgage fraud detection efforts and to answer any of your questions.

Thank you very much.

COMMISSIONER GRAHAM: Thank you, Mr. Rubin.

Ms. Ellen Wilcox.

MS. WILCOX: Hi. Mr. Chairman and distinguished Members of the Committee, my name is Ellen Wilcox and I'm with the Florida Department of Law Enforcement.

FDLE Special Agents investigate complex felony cases that cross jurisdictional lines. I would like to cover some of the problem areas that we have encountered in investigating mortgage fraud.

Number one, our mortgage fraud investigations are complex, paper intense and lengthy. The cost and length of these investigations make them less

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attractive to most investigative agencies and prosecutors trying to justify their budgets based on investigative statistics.

The FDLE case known as Florida Beautiful was opened in 2005. The case had already been developed and worked by Tampa Police Department and the Hillsborough County Consumer Protection Agency for almost a year before FDLE became involved.

During the five-year investigation, ten investigators and two prosecutors contributed significant time to this task force. Over 250 subpoenas were served resulting in tens of thousands which were all reviewed and analyzed. The investigation resulted in 18 arrests. The defendants ranged from the construction foreman to the processor for the mortgage broker business to the mortgage broker and up to a Vice President of a national subprime lender. Sixteen of the eighteen have been convicted at trial or have pled guilty.

Our second problem is Statue of Limitations. Most mortgage fraud will not be reported until the loan has gone bad, but the crime occurred when the money was lent. So if there was a fraud in granting a mortgage loan in 2004, in Florida the

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Statute of Limitations has already run.

Need for a witness from the lender. The witness must identify the document that was critical to their lending decision. The witness must then testify that if he had known these documents were fraudulent, he wouldn't have loaned the money.

We have spent an exorbitant amount of time trying to find a witness for a now defunct lender. When I find a former underwriter or account manager, I explain to them that he needs to be available to testify on behalf of a company that he no longer works for. Then I tell them that we will be paying actual expenses plus a $5 witness fee. A trial subpoena requires their current employer to release him to testify, but it does not require that employer to compensate him for the time missed. This doesn't leave a lot of incentive for people to testify on behalf of the State.

Our fourth problem is a need for documentation from both the lender and the title company. The lender's file provides the information about the lending decision and the documentation provided by the borrower and/or the broker to support that

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lending decision. The title file allows the investigator to follow the money.

If the lender and the title company are out of business, how can we find the records? Under Florida law, the records retention for these companies is not standardize, and if a company goes out of business, most destroy their records. In most cases, a copy of the lender file can be obtained by contacting the loan servicer, but we are now facing court challenges but for the use of this file from a loan servicer.

Number five, no originals of the originating information for the borrower. If the information on the loan application is false, how does an investigator prove who put down that false information? Was it the borrower, the mortgage broker, the lender representative?

One defendant has put forth the defense that the information and the documentation passed through so many hands that the State could never prove exactly who put down false information and provided the false supporting documentation.

Number six, in Florida, title companies are allowed to use mobile notaries to handle any

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closings that do not occur in their office. A mobile notary does not go over any documents being signed. He just points out where the documents must be signed. In almost every investigation where the borrower or an investor claimed that they just signed the documents, a mobile notary was used. In the Florida Beautiful case, the mortgage broker paid his employees to become notaries so that they could handle the closing and control what a borrower saw and signed.

Seven, our last problem, and it's probably our biggest, is intent. We have numerous cases where the investors were brought into the scheme to make money from flipping houses. What do we do with that investor? If the State charges the investor with submitting a false loan document, his first offense is that he gave the correct information to the mortgage broker and it was the broker that passed on the information to the lender.

A prominent defense attorneys stated that there is a distinction between false documents and fraudulent documents. Fraudulent documents imply intent. His client may have signed documents with false information but did not have any intent to

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defraud that lender. Therefore, with no intent, the client has not committed a crime.

These are the type of problems that we're having to deal with and the mortgage fraud problem is not stopping. It's just continuing. And charging these investors with the mortgage fraud is doing very little to defer future mortgage frauds.

Thank you.

COMMISSIONER GRAHAM: Thank you, Ms. Wilcox.

Mr. Black,

MR. BLACK: Yes, Senator

COMMISSIONER GRAHAM: reference your testimony on appraisal fraud, you seem to say that the marketplace has not shown the capacity to control this problem; that is, that the ultimate users of the information, the lenders, are not looking behind the appraisal to determine its credibility.

MR. DENNIS BLACK: Well, they have a little reading to do, because like the prior session talked about, these people are paid based on production. Their compensation packages are based upon selling money, and an appraisal is only a bump in the road.

So I once remember something coming out of Fannie Mae where they were talking about the fact that the overwhelming number of the appraisals that they see committed the sales price. It's an open secret in the appraisal profession that you -- that mortgage brokers and lenders would shop for an appraisal until they got the one that supported the number they needed and the other one they received would just be tossed.

So of course the one that ends up being in the secondary mortgage matched the sales price, because that first originator shopped until they got the number they needed. And they were also culling the herd, because any appraiser that didn't come up with that number wasn't getting a call the next time.

COMMISSIONER GRAHAM: We held a hearing in New York on the issue of the rating agencies where there was somewhat the same criticism that a person who is about to issue some publicly traded instrument would shop among the three or four rating agencies until they found one that would give them the rating that they needed in order to be successful in their marketing effort. This led to a provision in the recently passed federal legislation that essentially is going to now set up a system wherein rating agencies are blindly

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assigned to applicants for a rating for a particular security, so the applicant won't be able to shop around for the most favorable one.

Would something analogous to that be practical in the appraisal business?

MR. DENNIS BLACK: I think it would be disastrous, because not all appraisers are created equal. One of the problems now is the home valuation code on conduct essentially removes originators from the selection process, but the selection process became through a series of appraisal management companies and they would go by low bidder. There have been stories over the past 18 months of appraisers traveling a hundred miles to come to another market to perform the valuation of a property that they knew nothing about the local market.

So blindly picking certified appraisers I think can be a tremendous disservice and actually becomes problematic. I think the correction becomes from the standpoint of, well, just the stick, no carrot. The appraisal boards across this country need to be sufficiently funded so that appraisers who step out of line find themselves on the outside very quickly. And so instead of being left with the people who are willing to hit numbers, we are left with the honest, ethical, competent ones. So it doesn't matter who the lender chooses, because you're picking from a good pile.

COMMISSIONER GRAHAM: Here in Florida what has been the record of the licensure agencies for appraisers?

MR. DENNIS BLACK: Here in Florida it has been exemplary. One of the things that was in my qualifications, I also sat on a -- as a national director for one of the appraisal organizations and also on the National Professional Standards Board. So I've had quite a bit of interaction with people from the boards across the country.

Here in Florida, tremendous efforts. When they have a solid case, they proceed forward and the punishment that is meted out is quite substantial. Over the past two years, they have been averaging 25 revocations or long-term suspensions at each meeting, and they meet six times a year. So they're showing 150 people a year the door.

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COMMISSIONER GRAHAM: And what's the universe? What's the total number?

MR. DENNIS BLACK: Well, the total number of appraisers within the state of Florida at the height was approaching 20,000. That number is probably down around 11,000. We're about to go through a renewal cycle December 1st and I believe we will see more people dropping out.

Unfortunately, the people we're seeing drop out are the people who can't make it in today's world. I'm very fortunate because of my background and I'm handling a lot of the litigation work relating to those cases. But the typical residential appraiser who was just trying to put forth an honest opinion of value that was supportable, too often the person does not get called back for a second assignment.

COMMISSIONER GRAHAM: Mr. Gallagher, you talked about the task force that's been established and 18 personnel assigned to enforce mortgage fraud, the new state legislation. How many prosecutions have been held let's say in the last three years in Dade County on mortgage fraud?

MR. GALLAGHER: Prosecutions, I can't give you

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that figure, but I can tell you how many people we've arrested. We have arrested since 2007 -- October 2007 was the inception of the task force -- we've arrested 239 people for mortgage fraud which represents approximately 91 individual cases. We take those cases to the State Attorney's Office, to the statewide prosecutor, and to the U.S. Attorney's Office. And we've had prosecutions in all three of those arenas.

COMMISSIONER GRAHAM: One of our witnesses in the previous panel, Mr. Black, talked about the control fraud and the fact that many of these fraudulent activities are the result of the decisions made at the highest levels of financial institutions. Are some of those 235 people that have been arrested, did they meet that definition?

MR. GALLAGHER: I would say that the way we work our cases is we generally -- we get a complaint, and usually it's at the lower level, and we work our way up. Do we have cases that have reached into some banking institutions? We do. However, I don't know that any of our closed cases have reached that level.

COMMISSIONER GRAHAM: We'll probably be

following up with some written questions to get more details about the state of prosecution.

Mr. Rubin, your institution has the reputation of being one of the first who has desisted from activities which had the appearance of facilitating fraud. What were the warning signals that JP Morgan saw and what did you find to be the most effective, productive responses to those warning signals?

MR. RUBIN: In terms of the warning signs, we saw an expansion of an array of mortgage products, including some products that we chose not to offer such as negative amortization loans, which would mean the principal would exceed at the time of payment of the loan. We saw a loosening of underwriting standards, as I mentioned, the no-doc and no-income-check loans. We certainly saw that the third party lending by mortgage brokers where we were not as the institution dealing directly with a consumer, yet a third party was involved, we saw problems in that book of business as we looked back.

So we quickly undertook to curtail and stop certain items. So there are about five

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different items that I want to mention briefly.

First are the program changes. We eliminated back in '07 no-doc, no-ratios, as I mentioned. We eliminated stated-income and asset in '08. We discontinued our wholesale line of business in January of '09 so that we do not originate with third party brokers. This substantially enhanced -- we substantially -- excuse me -- enhanced our mortgage underwriting standards returning to more traditional 80 percent loan-to-value ratios entered by the borrower to document their income.

We relate it to the appraisal comment. We are very much in favor of appraisal independence. We've limited the Chase communication to our appraisers so we did not disclose, an example, who the appraiser was to our originators. We didn't disclose the loan amount to our originators to give the opportunity for the appraiser to provide an independent evaluation. We installed automated fraud tools so that we could provide tools to our underwriters to detect fraud. We required training of all of our personnel, not just underwriters, but loan officers as well.

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And training was not a one-time thing. It's ongoing training. We do it today. As an example, we are always looking at the latest things and we actually take case studies from loans that went bad and teach the underwriters, You see, here were the warning signs, here were the things that you could have done differently, and then we go ahead and put in new policies.

And finally, we've introduced very specific performance monitoring to monitor the underwriters and the loan officers on the quality of their book. Not how many loans they originated, but how well are the loans that they originated performing? And that is a part of their performance management process, so that they know and we know that quality is not nice to have, but is the most critical element in the production of a loan. And we want to make sure that we're providing our buyers the ability to pay and we want to make sure that all staff at JP Morgan Chase, from underwriters to loan officers, are adhering to that philosophy.

COMMISSIONER GRAHAM: In the previous panel, one of the reasons given for the failure of people up the chain of the mortgage business not intervening aggressively was that their compensation was in many cases based on the volume of throughput and not the quality of what went through the system.

What kind of compensation did you have for the people who were making these decisions to shelter yourself from these potentially fraudulent loans? How did you reverse the incentive structure?

MR. RUBIN: I'll take that in two parts, one, to describe what was done and then to briefly describe what we're doing today.

At the time, we always maintained an independence of operations so that the operations and underwriting staff were always apart and separate from the loan originators. So loan originators, their job was to take the application and they got compensated based on the closed loan. The back office, the underwriters and operations, were instead compensated based on decisions. So whether they declined a loan, approved a loan, it was really -- it was not indifferent. It was indifferent to us. We wanted to make sure that they had the proper tools to do their job.

To strengthen that, we've recently implemented some additional criteria. So, as an example, for our underwriters today, we have -- each underwriter is measured on a score card which will look at their performance on the basis of first payment default, on early payment defaults, how many loans, for example, went 60 days late within the first months of operation. We do -- and I think earlier in one of the panel's discussions, they asked does any bank do prefunding reviews? We actually re-review a minimum of three loans per underwriter per month that we grade and assess how well they're doing. And that's a very important component to their work that they do.

But the bottom line is quality is the pass/fail. If you don't pass quality, you get no incentive. So that is, again, a critical mission that if you ask any underwriter out there, quality is number one in their head.

Thank you.

COMMISSIONER GRAHAM: Thank you, Mr. Rubin.

I am going to exercise the prerogative of the chair and assign myself an additional one minute so I can ask Ms. Wilcox a question.

Ms. Wilcox, under the 2007 state law that was

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referred to by Mr. Gallagher, have you had referrals by either law enforcement agencies or the private parties to FDLE which have led to an investigation into mortgage fraud?

MS. WILCOX: The cases that I've been involved in, we have not yet used that statute. The statute went into effect in 2007, so we can't charge it unless the loan was originated after the statute was enacted. So we are still using the grant theft statute and the racketeering statute and the organizing scheme to defraud statute in our cases, because we're still looking at 2005/2006 loans.

COMMISSIONER GRAHAM: And you have not had any referrals to you under the 2007 --

MS. WILCOX: We do have referrals, all kinds of referrals all the time from -- a lot of our cases are based on the SARs.

COMMISSIONER GRAHAM: Thank you very much.

Ms. Murren?

COMMISSIONER MURREN: Thank you, Senator Graham.

If I could begin with a question for Ms. Wilcox and Captain Gallagher about the way that you focus your activities as it relates to mortgage fraud. Because one of the things that strikes me too was that there is a lot of discussion about mortgage fraud that is perpetrated by the person who is the recipient of the loan as opposed to the lender, the broker or the appraiser, and I was wondering if you could comment on your desire or capability to be able to explore fraud that may take different forms.

Would you like to begin, Captain?

MR. GALLAGHER: Sure.

Well, the Mortgage Fraud Task Force, the law enforce component in our department is an Economic Crimes Bureau. We deal with all kinds of fraud. So whenever someone comes and presents us with some sort of scheme, whether it involved mortgage or not, we're going to look at it. We don't shy away from anything. Whatever they bring us, we'll take a look at it and we'll analyze it, and if it does appear to us that there's some sort of crime, we'll consult with a prosecutor -- again, it could be any one of the three levels -- and we'll determine whether there is merit to continue an investigation into it basically looking at if the elements of a crime exist. And if they do, we'll go ahead and we'll investigate it.

We partner regularly with federal agencies and state agencies. So if it's a question of jurisdiction or something like that, if it's out-and-out jurisdiction, out of town, obviously if it's not Florida, we're probably just going to go ahead and give it to the appropriate agency. But if's something that has a link to Miami-Dade County and it goes beyond our boundaries, we'll either partner with the state or with the federal government.

COMMISSIONER MURREN: We've heard testimony previously from folks from different agencies who have said that sometimes they choose not to pursue certain things because the threshold dollar amount may not be sufficient to warrant their attention. That is not a limitation for you?

MR. GALLAGHER: No, no mortgage fraud case -- we don't have a threshold for mortgage fraud as far as dollar amount is concerned.

COMMISSIONER MURREN: And how about the different parties involved? Is it your feeling that you end up spending more of your time on people that have taken a loan as opposed to other people that have been involved in the process? For example, how many appraisers have you brought a criminal investigation against?

MR. GALLAGHER: I don't know exactly how many appraisers, but I can tell you that we do end up arresting a number of -- well, we have arrested a number of mortgage brokers. We have arrested -- it's the full spectrum. We've gone from getting attorneys and individuals who work at banks all the way down to the guy who has been committing crimes for the last 20 years of his life.

So you have people of all walks of life involved. We're going to focus on whoever is involved. If the attorney is involved, we'll focus on the attorney and we'll address that. And if it's just a straw buyer who has no legitimate standing in the real estate industry but they committed the crime, we'll also focus on them. But it depends on what the case brings. Every case is different.

COMMISSIONER MURREN: Thank you.

Ms. Wilcox?

MS. WILCOX: The Florida Department of Law

Enforcement, by statute we have to look at cases that are multi-jurisdictional. So we look at the bigger cases, the more lengthy cases that involve the mortgage brokers, that involve a ring of organized criminals trying to defraud the industry. So we will include the appraisers, the mortgage brokers, the realtors, the lenders. Like I said, in Florida Beautiful, we were able to get a Vice President of the subprime lender in that case. So we will try to address the higher levels and maybe not necessarily charge individual borrowers, but use them to make our case against the next level of the perpetrators.

COMMISSIONER MURREN: Thank you.

I have a question now for Mr. Rubin. If you could talk a little bit about your involvement currently with the mortgage modification program. I would think as the underwriting chief that you would be knowledgeable about that, and perhaps if you could comment a little bit on what's happening with that process. A lot of the testimony we've heard actually in the field hearings is related to the fact that people, broadly speaking, have had difficulty being able to utilize some of the programs that have been put in place, and I was wondering if you could talk about what your feeling is about that.

MR. RUBIN: First, just by way of background, I am the chief underwriter of our production shop, which means when loans are originated from start to when the loan funds. I have some limited knowledge of the modification program which I will address which is your question, but I'm not an expert in the modification space.

We clearly focus our initial efforts on providing affordable payments for those who want to maintain their homes and have a reasonable ability to make and sustain affordable monthly mortgage payments.

We have Chase homeownership centers. Here, for example, we have opened -- there are 11 in the state of Florida, one here in Miami, where we encourage borrowers who are having difficulties either making their payments, need to talk to someone, have counseling, can come in, meet with our individual staff. And these homeownership centers are located throughout the country so that we can help and navigate a consumer through, what I believe you're addressing, some of the difficulties in completing the paperwork.

We have offered over 700,000 modifications to struggling homeowners and completed over 110,000 permanent mods under what's called the HAMP Program, the Home Affordable Modification Program, and other modification programs offered by the GSEs or by FHA and VA. So these are programs designed for those who are struggling and can't pay.

There are also programs on the origination side, which I'm even more familiar with, the Homeowner Relief Program. Some of the agency modification programs, the no-cash-out finance where borrowers have an ability to lower their monthly payment. And we have originated many, many, many hundreds and thousands of loans so that it's really both for those who are able to pay but need the lower their payment and the future difficulty as well as those who are having difficulty through the modification program.

COMMISSIONER MURREN: As an outside observer of this process, it does seem as though there is gridlock in the system for being able to modify. Again, broadly speaking. Not specific to your firm.

As an insider who is familiar with the process, what do you think is wrong? Do you think that there are too many people that are going in to have modifications at one time so that the infrastructure that's in place is overloaded? Do you think that people are not accustomed to this process and have to learn it from someone who's at the bank and on the outside? Or do you think it's that the bank's lack of financial incentive to actually complete some of these transactions? Just based on your knowledge of the industry.

MR. RUBIN: Based on my -- to the best of my knowledge, it certainly is not the latter. It's in our best interest at JP Morgan Chase to make as many of the modification offers. We want customers staying in their homes. We want people making their monthly payments.

I believe some of the difficulties are exactly some of the points that you had made. We, for example, I know needed to hire many staff. I don't have the exact number, but I know it was more than double our staff to handle the influx of volume. It's complicated. There's paperwork involved. We want to make sure that we are documenting the note and documenting incomes so that we are sure there is a need and that we're providing the modifications to those who need it. We want to make sure that we don't repeat some of the other lessons that we've learned in the past.

But certainly this is an incentive for us to do it, and we are always looking to find ways to enhance the process. And one of the reasons why we opened these homeowner centers, we felt it was very important for an individual to be able to reach out and talk to someone and meet in person, particularly in the impacted areas.

So I believe Chase has been a bit more successful than others, but it's clearly a daily struggle and we're always looking for ways to improve and enhance to ensure that we're giving modifications to those who are deserving of it.

COMMISSIONER MURREN: I'm not sure that I understand what the incentive is for the banks to modify the mortgages. Because my understanding is when a loan is modified, that there is an immediate write-down that has to occur in the quarter that it was taken. Is that correct? Do you know if that

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is true?

MR. RUBIN: I'm not familiar with accounting treatment. But in terms of the incentive, a loan that is not performing, the customer is not making their payments, is a negative consequence to both Chase as an institution and our reputation as well as if the loan were sold to whoever the investor was.

But, again, the way we think of it and I think the way everyone really should be thinking about it, regardless of whether originating a loan for sale for our own portfolio, we did it. We started it. We want to make sure that we have done all the due diligence. So it's important that that customer is paying. If they're not paying, then we do everything to we can to keep the monthly stream in place. Foreclosure doesn't really help anybody except, you know, we're trying to do the right thing first. And that's why we've dedicated our efforts, and I believe most of the other -- certainly our peer groups are doing the same.

COMMISSIONER MURREN: All right. Thank you. I don't mean to pick on you on this subject, but it's come up repeatedly as we've talked to people in the community. Thank you.

COMMISSIONER GRAHAM: Georgiou?

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman.

Captain Gallagher or Agent Wilcox, I want to commend you both for your hard work in moving these criminal prosecutions along. And of course I think that work is extraordinarily important in ensuring the integrity going forward in the marketplace. But by the nature of criminal investigations and prosecutions, you're working on cases that have already occurred where mortgage fraud has already happened and, you know, you have to do the extremely taxing and demanding work to do the investigations, document it, and try to establish intent and all the other criteria that go into a criminal prosecution.

Again, I commend you for your work. But I'm trying to focus on private market incentives. And I want to turn to the other two of the panelists to ask a question, a couple of questions in this regard, to see what practices you believe contributed to the decline in underwriting standards and the decline in quality of originations of mortgages themselves and the other stages in the process.

Mr. Rubin, I wonder if you could tell me in your compensation structures what, if any, disincentives, that is declines or clawbacks in compensation or declines in the awarding of bonuses, results from the various parties that you supervise who underwrite and award and permit a loan to be made that ultimately defaults to the detriment of either your institution or the ultimate purchaser of the loan.

MR. RUBIN: In terms of the underwriter incentive, what I'm most familiar with, our current plan today provides a base salary to an individual and --

COMMISSIONER GEORGIOU: I'm sorry. If you could turn your mic a little more towards you if you could please.

MR. RUBIN: I'm sorry. Can you hear me now?

COMMISSIONER GEORGIOU: Yes.

MR. RUBIN: In terms of those who I supervise, the underwriting staff, each underwriter has a salary and then an incentive basis. The way incentive is derived, as I was mentioning earlier, is specifically first and foremost quality of their originations, meaning how well have those loans performed and how well is the underwriter adhering to the underwriting standards that we've set forth. So --

COMMISSIONER GEORGIOU: How do you evaluate how they've performed? How long a tail do you evaluate those loans?

MR. RUBIN: So we look at a variety of factors. The first is payment default, which is the first 60 days. So typically if there was a mistake made up front as the underwriter wrote it, we find out pretty quickly. We also look at them from a longer term horizon. We look at -- over a 24-month period, we look at that -- during the last 12 months, did any of those loans go bad 90 days or more? So, again, the implication of longer-term incentive, but -- longer-term performance.

COMMISSIONER GEORGIOU: And what financial consequence occurs to the underwriter if there is a failure, if there is an early default, first payment default or a subsequent default?

MR. RUBIN: Right. So if we look at each of

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those and if it was something that the underwriter could have, should have seen, done differently, then certainly they would receive no incentive bonus for that period.

If it's something, for example, a life event, a life cycle event where someone unfortunately lost their job and there was nothing that they could have done differently that would have avoided that particular default, then we would not have impacted them. But we also look at patterns and so we want to be reasonable to make sure that it was in fact their fault.

But on the other hand, if there is a pattern of excessive delinquency, we want to be able to look at any excessive delinquencies that again result in no incentives for an underwriter.

COMMISSIONER GEORGIOU: And this is -- these are loans underwritten directly by JP Morgan Chase?

MR. RUBIN: That is correct.

COMMISSIONER GEORGIOU: And how do these standards -- you said "we have implemented new standards". Those standards were implemented when? Did you say 2007 or '8?

MR. RUBIN: The standards that I'm describing right now are in place today in 2010. In 2000 -- I don't know the exact time frame. We always measure our underwriters on the basis of quality. We have continued to make it more sophisticated. In the past, we didn't take as long a term of view in terms of looking at loans over a 24-month period. It was a shorter period of time. I don't remember the exact details.

But the basic concept of what I'm describing of quality being from underwriter standpoint, their main measurement and metric of success has been in place -- I took this role in August of '08 as the chief underwriter, and certainly at that time we had strengthened -- began to strength the quality component.

COMMISSIONER GEORGIOU: And of course by that time, a lot of the bad loans had already originated. And your focus is simply on the loans directly originated by JP Morgan Chase, not loans that you might have purchased from other originators?

MR. RUBIN: Well, as I mentioned, we no longer originate through third parties, the mortgage broker business. We are no longer a part of the --

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COMMISSIONER GEORGIOU: When did that stop?

MR. RUBIN: January of '09 we discontinued our wholesale line of business.

COMMISSIONER GEORGIOU: But before that, you had a fairly extensive wholesale line?

MR. RUBIN: Yes.

So the wholesale business at that time, we still -- we underwrote the loans that were done by the brokers, third-party brokers, and we looked at the documentation they provided and the underwriter did what they -- they did their due diligence; but it was clearly something that we felt we needed to strengthen and ultimately eliminate because the best underwriters can still be looking at an income statement and a pay stub and think it's okay and find -- and underwriting to that effect only to find out later that it was a falsified document. But just to -- knowing that risk and knowing the delinquency, the decision we made to exit that business.

COMMISSIONER GEORGIOU: And you say that their up-side incentive is contingent on those standards. Do they have any down-side incentive? Is there ever clawback that results from the origination of the underwriting of a loan that defaulted?

MR. RUBIN: So, again, at the individual underwriter level, these are our first-line, second-line staff. So it's all based on current production for them at a senior level. There are other incentive programs which I'm not expert on to talk to on the underwriting side. There is no specific clawback for an underwriter.

But as I mention often to my staff, performance management -- incentive is not a substitute in performance management. Performance management is you're an underwriter. We provide you all the tools to do your job. We provide you with the training and support. And if you're underwriting and making bad decisions, you won't be working here.

COMMISSIONER GEORGIOU: All right.

Mr. Black, you said that one of the disincentives to high-integrity appraising was the selective hiring by originators and others who needed your appraisal services of people who didn't engage in this high-integrity appraisal process. Correct?

MR. GALLAGHER: Yes, sir.

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COMMISSIONER GEORGIOU: Can you tell us as an experienced appraiser and somebody who has been in this business for how many years? Twenty-five or so years?

MR. DENNIS BLACK: Thirty years.

COMMISSIONER GEORGIOU: Thirty years.

What market discipline would you apply to govern the appraisal process, which obviously we all know contributed fairly significantly to the inflation in housing prices to unreasonable inflation in housing prices?

MR. DENNIS BLACK: I think the best method is to have those regulatory bodies in each state be better funded and have more investigators and have more attorneys that can provide disincentives for not acting ethically.

COMMISSIONER GEORGIOU: I'm sorry?

MR. DENNIS BLACK: For not acting ethically.

The appraisal boards across the country are overwhelmed, here in Florida particularly. If I recollect, in 2008, they had 800 complaints in the state of Florida, against for - approximately 15,000 appraisers. They - overwhelmed.

I don't think there is a market mechanism, because too many of the origination side, they're not interested in it. And I can tell a story of a situation where a lender -- in a civil case that I was involved, the lender hired a review appraiser to check on the original appraiser. The reviewer they hired had been an appraiser certified for four months. Now, they had served a two-year apprenticeship as a trainee prior to that and I do want to talk a little bit about appraisal entry.

January 1st, 2008, the qualifications for becoming an appraiser changed dramatically as compared to what happened prior to that. But this person had been a certified appraiser for four months and that's who the lender turned to to review the quality of someone else. Well, the funny thing is by the time I was involved in this case 18 months later, that review appraiser had already been disciplined and revoked by the State of Florida.

So that I think state has to be that the regulatory bodies are able to really demonstrate to appraisers that there is someone watching them; that if they step outside the bounds of good conduct, they will not be long for this profession.

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COMMISSIONER GEORGIOU: Is there -- can you -- you don't think market mechanisms work or you can't think of a market mechanism --

MR. DENNIS BLACK: I can't think of a market mechanism.

COMMISSIONER GEORGIOU: -- in which you would attach in some way economic accountability to the appraiser in terms of the quality of their appraisals?

MR. DENNIS BLACK: There was something done by FHA back I believe it was 2005 or maybe 2006 that they started to grade appraisers based upon loan defaults. Well, the appraiser has nothing to do with loan default necessarily. As Mr. Rubin testified, there could have been life events or there would have been other things that happened that the borrower did a liar loan. The appraisal may have been entirely accurately and honestly prepared. So that becomes a problematic market solution by tying appraiser performance to loan performance.

COMMISSIONER GEORGIOU: What else would you be able to tie it to? I mean, I suppose one could argue that obviously the larger the appraisal, the

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larger the loan, the greater the risk of default, because the borrower is in a precarious position regardless of the life changing event. So there are some consequences. There is a heightened likelihood of default created by a mortgage that's inflated by an inflated appraisal.

MR. DENNIS BLACK: If it's created by an inflated appraisal, I agree one hundred percent. But it may have -- the problem with default may have been for an entirely separate reason other than the appraisal being inflated

COMMISSIONER GEORGIOU: Right.

MR. DENNIS BLACK: - or improperly prepared.

I wish I could come up with a market mechanism that would work because I would have people lining up to buy my product. I have thought long and hard about this. I cannot think of a market mechanism that I could step to the majority of lenders and say, You need this quality control. Approximately ten years ago, I attempted to form a company full of people who were certified instructors across the country and to lenders. These individuals were certified faculty members of the appraisal organizations within the country. And there was little interest in having appraisals reviewed by

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people who were highly qualified. So I don't know what the market mechanism would be.

COMMISSIONER GEORGIOU: How often is it the case, if you know --

Am I over? Just one more minute. Just this final question.

How often is it the case in your experience that appraisers are advised of the target price that they're asked to return an appraisal on?

MR. DENNIS BLACK: Well, that’s a double edge sword.

Fannie Mae requires in their regulations that appraisers be supplied a copy of the contract. The uniform standards also require that we analyze and report any current contract. But the uniform standards is also very clear that it should not be or intended to be a target. It is merely for informational purposes.

COMMISSIONER GEORGIOU: Well, but these informational purposes are essentially used--

MR. DENNIS BLACK: Too often --

COMMISSIONER GEORGIOU: -- as a guide and not for what the parties are expecting the appraisal to come back as?

MR. DENNIS BLACK: To often that is the case.

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I agree.

COMMISSIONER GEORGIOU: Thank you very much for your courtesy.

COMMISSIONER GRAHAM: I realize that we've run a little bit over. Can I just ask a question with a concise answer? In that case that you cited where the institution hired the four-months person to be the overseer of appraisals, was that institution a bank or some other lender?

MR. DENNIS BLACK: If I recall correctly, it was a mortgage brokerage firm.

COMMISSIONER GRAHAM: And was there any sanction against the mortgage broker for having hired such an apparently incompetent person?

MR. DENNIS BLACK: I don't know if they were sanctioned, but I certainly can point out that I told the attorneys who were involved in the civil case that that might be another path for them to investigate to demonstrate that there was lax underwriting standards when you're going and hiring somebody who's been a certified appraiser for four months to be your quality control reviewer.

COMMISSIONER GRAHAM: Mr. Thomas?

Thank you.

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VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

You know, I've heard this story before. In your opinion, Mr. Black, what percent of the certified appraisers -- is that what you call them, certified appraisers?

MR. DENNIS BLACK: Yeah.

VICE CHAIRMAN THOMAS: What percent of them are honest?

MR. DENNIS BLACK: I don't think I have insight to that.

VICE CHAIRMAN THOMAS: Sure you do. Sure you do. You know who it was that was doing it. You just gave us an example.

MR. DENNIS BLACK: I gave you an example. I can answer --

VICE CHAIRMAN THOMAS: How many examples could you give us? And then we could kind of get to the percentage. I don't have that much time.

Look, what you said was you need more government to stop us from behaving badly. That's what you just said; set up a government -- more guys in government to oversee what you're doing. That doesn't work.

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Now, I understand the peer group pressure, and normally the cliché is you don't want to be the skunk at the garden party. Apropos by location, you don't want to be the alligator at the garden party.

COMMISSIONER GRAHAM: Or the panther.

VICE CHAIRMAN THOMAS: Or the panther. I guess we're getting a few more panthers. We've had them for a long time and didn't kill them all off.

You know, when they talk about bad doctors, you know, you throw a figure -- I'm sure it's improbable, but pretty close -- 10 percent of the doctors commit 90 percent of the malpractice. And if you had reasonable peer group review, if you really were fundamentally proud of your profession -- I don't know. That's why I asked you the percentage. Three percent, two percent, one percent, or are you the Lone Ranger?

MR. DENNIS BLACK: I can give you some insight this way. Approximately 15 percent of the appraisers who are certified in the country belong to a professional organization. So that's the first thing. Eighty-five percent don't even want to belong to a professional organization.

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To answer the question --

VICE CHAIRMAN THOMAS: Is that because the professional organization doesn't do anything except collect dues and go to nice places outside of Florida for -- well, I guess for conventions you might want to stay here.

MR. DENNIS BLACK: This isn't a fact of the choosing of a quality appraiser. You will note in my qualifications that I hold the highest designation from three of the members of the appraisal foundation. Unfortunately, rarely does that come into play when someone is asking about hiring me. They ask me a question about price. They don't ask me a question about qualification.

VICE CHAIRMAN THOMAS: Okay. Just let me say this and then I'll move on: If you were serious, I think you could find enough folk, even the crew of the highest honored multiple rewarded people, to start naming names.

MR. DENNIS BLACK: As far as --

VICE CHAIRMAN THOMAS: If we could get the doctors to do that, you would see significant reduction in malpractice. Peer review is the best way to control it, but if the peers refuse to do what they bemoan about others from a professional point of view, it will never happen. You don't have to respond, because I know this is a concept that's really hard to understand.

MR. DENNIS BLACK: May I respond?

VICE CHAIRMAN THOMAS: Sure.

MR. DENNIS BLACK: All right.

VICE CHAIRMAN THOMAS: Apparently I have unlimited time.

MR. DENNIS BLACK: Under the guise of creating more government, that would be no different than Captain Gallagher's task force.

VICE CHAIRMAN THOMAS: Actually, it is because it would be you in the profession policing yourselves.

MR. DENNIS BLACK: Well, those complaints though are made to the licensing agencies in each state, and appraisers and organizations such as JP Morgan Chase regularly file complaints with the Florida Real Estate Appraisal Board and the Division of Real Estate for them to investigate and move forward.

VICE CHAIRMAN THOMAS: What about running an ad in the real estate section of the paper naming the appraisers who clearly have not been professional in what they've done?

MR. DENNIS BLACK: Well, I think prior to an adjudication of them being guilty of fraud or some other crime, I think it would be slanderous.

VICE CHAIRMAN THOMAS: Do you know some that it wouldn't be slanderous about? In fact, it would be true?

MR. DENNIS BLACK: I think that's something that needs to be proven in a court of law before I want to stick my neck out.

VICE CHAIRMAN THOMAS: No, I just asked you. Do you -- you don't have to -- you're not going to give me names. Do you know some?

MR. DENNIS BLACK: I suspect some.

VICE CHAIRMAN THOMAS: You suspect some?

MR. DENNIS BLACK: Well, I also have real -- if you want to speak during the lunch break.

VICE CHAIRMAN THOMAS: Yeah, yeah. See, this is one of the real problems. I hear it all the time.

Captain Gallagher, I'm looking at the evidence that you show in terms of fraud. You've got the one example of the sisters --

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MR. GALLAGHER: Yes.

VICE CHAIRMAN THOMAS: -- on the H-1 form. They give the seller the HUD-1 form that says 1,050,000 and they submit to Wells Fargo another HUD-1 that says 1,400,000.

MR. GALLAGHER: That's correct.

VICE CHAIRMAN THOMAS: How much investigative resources were involved in -- I mean, that's stupid, isn't it?

MR. GALLAGHER: But it's very common. It's -- the thing about this is they leave a paper trial when they commit the mortgage fraud. The hardest part is usually finding the paper. Because, again, you do have lenders that have gone under and it's a question of finding the documentation. But once we find the documentation, we're able to prove that they essentially created two HUD-1s. You'll find that one HUD-1 is for a larger amount.

VICE CHAIRMAN THOMAS: Sure.

MR. DENNIS BLACK: And they'll split the difference amongst themselves.

VICE CHAIRMAN THOMAS: So once you discovered that that may be something that's happening, you'd set up a routine comparison process or you've urged this to be done? Because that would simply -- all it is is a match, and when you get a mismatch, you've got the case.

Have you set up a structure to do that or talked about laws to do that?

MR. GALLAGHER: You mean in the private sector or are you just talking law enforcement?

VICE CHAIRMAN THOMAS: Well, if they filed it -- the HUD-1, you have to file it with some government agency.

MR. GALLAGHER: Well, yes.

What happens is, if I'm not mistaken, you've got the broker's office who's got a HUD-1.

VICE CHAIRMAN THOMAS: Yeah.

MR. GALLAGHER: You'll have the title company who will have a copy of the HUD-1 and then you'll have the lender who's got a copy of the HUD-1.

VICE CHAIRMAN THOMAS: So there's a lot of HUD-1s around.

MR. GALLAGHER: Correct.

And then the question is, you have to take a look at all of them and see if there is any discrepancies. And when you do find a discrepancy, now you know you've got mortgage fraud. Then it

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becomes a question of who is benefiting from the discrepancy? Is it the mortgage broker? Is it the lender? Who is it? And so there is where the investigation comes in. And then you have to also determine who created the discrepancy.

Again --

VICE CHAIRMAN THOMAS: Do the appraisers get a copy of the HUD-1?

MR. GALLAGHER: I don't know. No, we do not.

VICE CHAIRMAN THOMAS: Okay. You're off the hook on that one.

Jack Rubin, I'm trying to figure out how much we should charge you for the commercial you've delivered so far. You referred to your peer groups. Who in your opinion are the peer groups that you were referencing?

MR. RUBIN: The other large national lenders.

VICE CHAIRMAN THOMAS: Oh, run off some names. Or are we not allowed to ask you that?

MR. RUBIN: Citi, B of A, Wells.

VICE CHAIRMAN THOMAS: Anyone here tried to get-- we've had some people earlier who I knew, but I can't see them now. Anyone here tried to modify your loan and not been successful? Who are you with?

AUDIENCE MEMBER: I'm a mediator. I do foreclosure mediations.

VICE CHAIRMAN THOMAS: No, I want a real person who's gotten stuck. We've had them at other hearings. You can give me third-party examples. That's okay. I know you have them. But apparently JP Morgan Chase is.

How long have you been JP Morgan Chase?

MR. RUBIN: I don't know the exact point when JP Morgan and Chase merged. I don't know the exact date.

VICE CHAIRMAN THOMAS: This century, the 21st Century?

MR. RUBIN: Recently.

VICE CHAIRMAN THOMAS: Recently.

When did you move from Chase to JP Morgan?

MR. RUBIN: I've been employed -- I started my career at Chemical Bank in 1983 and later merged with Chase and I've been a Heritage/Chase employee for many, many years. And JP Morgan was really -- from a mortgage perspective was really the Chase entity and the arm that continues to --

VICE CHAIRMAN THOMAS: Well, when did JP

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Morgan pick up Chase?

MR. RUBIN: I don't have the exact -- I can get it to you.

VICE CHAIRMAN THOMAS: Well, you moved over from Chase to JP Morgan Chase.

MR. RUBIN: I didn't --

VICE CHAIRMAN THOMAS: You don't know?

MR. RUBIN: My business card changed, but my position stayed the same, where I sat stayed the same, my phone number stayed the same.

VICE CHAIRMAN THOMAS: And the exemplary Five Point Program that you've been involved in has stayed the same? No, it's changed. Your third party -- your rejection of third party origination was in January of '09. You have that date.

MR. RUBIN: That's correct.

VICE CHAIRMAN THOMAS: Okay. So you acquired some bad loans?

MR. RUBIN: Yes.

VICE CHAIRMAN THOMAS: How did you resolve it with those in the company that processed them?

MR. RUBIN: We closed down those operations.

VICE CHAIRMAN THOMAS: And what about the people? Was there a pattern in terms of some doing it more often than others?

MR. RUBIN: We looked at each of the underwriters that were involved in those particular loans, and when opportunities came up for employment in other parts of Chase, those that had -- that we believe were from a delinquency point of view had poor quality production were not offered any employment.

VICE CHAIRMAN THOMAS: They were not offered any employment.

MR. RUBIN: Let me be clear.

VICE CHAIRMAN THOMAS: You fired them or you moved them to a different division?

MR. RUBIN: When we closed our mortgage broker channel, we closed all of our offices, which means all of those employees were let go.

VICE CHAIRMAN THOMAS: Okay. Last question. I've got four minutes left on my overrun.

Ms. Wilcox, you talked about multiple opportunities for state law change initially in terms of all the frustrations you've had in trying to accomplish what you accomplished, but we had noted the '07 law that was passed.

Did that close all of them, some of them, or are you aware of major loopholes that have not yet been closed by the '07 law?

MS. WILCOX: Yeah, we still have -- there are still some areas that we could probably get some new laws or changes to some laws that would help.

VICE CHAIRMAN THOMAS: So some of the practices, notwithstanding being investigated by law enforcement, have not been changed under state law?

MS. WILCOX: No, some of them have not. Some of them we are still trying to get some changes, yes.

VICE CHAIRMAN THOMAS: Okay. So Carl Hiaasen has a chance for yet another novel focused on Floridian activity.

Thank you, Mr. Chairman.

COMMISSIONER GRAHAM: Well, we have made one contribution to expanding the marketplace, I think one for reading.

Mr. Chairman?

CHAIRMAN ANGELIDES: Yes. Thank you.

Mr. Black, let me ask you about this 2007, this petition in December 2000 and signed by 11,000 appraisers. This was addressed to Executive

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Director of Appraisals Subcommittee of?

MR. DENNIS BLACK: This Appraisal Subcommittee is formed with the financial -- by way of a law signed in 1998, the Executive Subcommittee was created and it consists of a chair in the Federal Reserve, the FDIC/OTS, national credit unions. So that is the Appraisal Subcommittee of the United States Congress.

CHAIRMAN ANGELIDES: The Subcommittee of what?

MR. DENNIS BLACK: Of the U.S. Congress.

VICE CHAIRMAN THOMAS: No.

MR. DENNIS BLACK: The Appraisal Subcommittee is the way it's always been referred. It is comprised of those five entities.

CHAIRMAN ANGELIDES: And they wouldn't be related to the Congress.

MR. DENNIS BLACK: Well, it’s federal.

CHAIRMAN ANGELIDES: So what you're saying is subject to FIRREA --

MR. DENNIS BLACK: Correct.

CHAIRMAN ANGELIDES: -- an entity was established in the federal government --

MR. DENNIS BLACK: Correct.

CHAIRMAN ANGELIDES: -- with respect to appraisal standards?

MR. DENNIS BLACK: Yes.

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CHAIRMAN ANGELIDES: All right. Well, I'll either ask our staff or you if we can get some clarification on the actual nature of the entity.

So just to be clear, this petition was started in 2000 expressing concerns about significant problems in the appraisal business; the withholding of business, if there was a refusal to inflate values, withholding of business if we refuse to guarantee a predetermined value. So 11,000 appraisers signed that you said from the time it commenced prior to its closing for signatures.

Do you remember when that closing was?

MR. DENNIS BLACK: I believe it to be a closure of signatures in 2006 or '7.

CHAIRMAN ANGELIDES: Okay. So during that six-year period, 11,000 appraisers took the time to go on and essentially warn the federal government about problems in the industry?

MR. DENNIS BLACK: Yes.

And a good percentage of people. For example, I was signature I believe 647 and I signed it about one month after its inception. So very quickly a large percentage of those 11,000 were on board.

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CHAIRMAN ANGELIDES: Were you aware of any action taken be the Appraisal Subcommittee in response to that petition?

MR. DENNIS BLACK: No, I'm not.

CHAIRMAN ANGELIDES: All right. I'm going to ask our staff if we could follow up on that.

To what extent -- you know, I know Mr. Georgiou asked you about some business model questions and let me just follow up. To what extent do you believe that the pressures you faced were caused by the business model of the origination to distribute model?

MR. DENNIS BLACK: I think a large percentage of one, because it was that financial hot potato. I originate this loan and I move the risk on. I collect my commission. So I'm not all that worried about whether or not the appraisal valuation and the valuation of collateral was accurate and honest.

CHAIRMAN ANGELIDES: Was this lender driven -- from your perspective lender driven or mortgage broker driven? Who at your level was driving the train that pushed the envelope?

MR. DENNIS BLACK: I think all parties were

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guilty, but if you get into the mortgage brokerage world, the third-party originators were more apt to go down that path as opposed to in-house originators. Because they were clearly --

CHAIRMAN ANGELIDES: Compensation structures?

MR. DENNIS BLACK: Pardon me?

CHAIRMAN ANGELIDES: Compensation structures?

MR. DENNIS BLACK: Absolutely.

CHAIRMAN ANGELIDES: Less control?

MR. DENNIS BLACK: Yes.

CHAIRMAN ANGELIDES: All right.

Mr. Rubin, let me ask you this question: You talked about JP Morgan change and reform in its practices. Let me just take you back, because you've obviously been with the institution for a while. What was the rationale behind what the industry even itself began to refer to as liar loans? What was -- you know, I know that some people have told me, Well, technology advances, rapidity of movement. But I'm thinking how hard is this to supply W2s and verification of income? Really what's the rationale or justification for a lender eliminating that essential credit check? And internally when this was happening, give me your view. Not so much about the fact that it was eliminating '07, '08, with all due respect, after the horse is out the barn.

When did JP Morgan Chase go to this form of loan to what share of the market was it in the heyday and what was the rationale?

MR. RUBIN: I don't know the exact timing, but I do know we were relatively late to offer the no-doc loans.

At the time -- and this has gone back -- we felt we were providing a loan that appealed to a specific segments of borrowers that we believed were creditworthy but didn't want to provide what at the time may have been very complex documentation.

So at the time when we started it --

CHAIRMAN ANGELIDES: Complex documentation being what?

MR. RUBIN: So if you were a self-employed borrower and had multiple tax returns, instead of just providing the normal 1040, we would analyze the business returns. So if you went to a borrower and asked for --

I'm sorry.

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CHAIRMAN ANGELIDES: If you have an S-Corp, you provide the S-Corp or -- right?

MR. RUBIN: But many had multiple businesses.

So at the time -- and, again, this is -- you asked me to kind of retrospectively look back. That was the rationale that we thought there were generally higher net worth borrowers that this made sense for that didn't want to go through the hassles of giving the paperwork. And that was certainly the rationale at the time. Speed on the process may have been another. But honestly it was really more the creditworthiness is how we got into it.

Unfortunately, as we all now know, it became a tool for many enabling opportunities to those interested in committing mortgage fraud to lie about it, and we changed it. We would have certainly preferred to have changed it much earlier than we had. But at the time we went into it, it wasn't, Let's go in with a loan -- so it doesn't have to disclose their income and let's give it to them. It was totally --

CHAIRMAN ANGELIDES: Well, I know it started with high-net-worth individuals generally, repeat

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borrowers, so let me ask you. The 2005 to 2007 time frame, what percentage of your residential loans became some form of a no-doc-stated-income loan?

MR. RUBIN: I don't have those figures as to when, but I can certainly get those to you.

CHAIRMAN ANGELIDES: What was the magnitude roughly? Are we talking about one in ten, one in three?

MR. RUBIN: I don't know. I really can't venture a guess. It wasn't the predominant -- that I can tell you. It wasn't the predominant loan, but it started off slowly because of the type of borrower we were targeting. But it got bigger. But I don't have the exact number.

CHAIRMAN ANGELIDES: All right. Follow up and please get us that.

The other question I have for you, just very briefly -- I'm going to make a commitment not to go over my time. Just very briefly, what specific measures did you undertake in your shop with respect to fraud protection?

MR. RUBIN: We, for example, did post reviews, so after the fact we have a quality assurance department that would go back and --

CHAIRMAN ANGELIDES: What about pre?

MR. RUBIN: Prefunding, we would get an executed 4506-T which is a document that allows us to go to the IRS to get the actual tax return. We would go ahead and -- for example, in the state of Florida, that was one of our requirements that we not only got it signed but executed, meaning we got copies of tax returns, compared it to what was submitted, and if there was any discrepancy, then we did not -- any material discrepancy, we didn't do the loan. That's one example.

We did independent verifications of employment.

CHAIRMAN ANGELIDES: That was on every no-doc or limited-doc loan?

MR. RUBIN: Every no-doc and -- yes.

CHAIRMAN ANGELIDES: So you would then --

MR. RUBIN: Excuse me. The 4506-T we did not implement until July of '08 is when we mandated --

CHAIRMAN ANGELIDES: Yeah. Forget that for a minute. I'm asking during the run-up. What did you do in the '05 to '07 -- by '08 the market is dead. So what did you do specifically in the kind of '04/'05 run-up period? What were the specific measures taken by your shop to detect fraud?

MR. RUBIN: So the training that we provided our underwriters was one of our critical elements. Providing them, you know, specific opportunities to look at here's a Social Security Number here, a Social Security Number there. You need to do a comparison. For appraisals, you need to do a comparison of are they using the right comparables?

So it was an intense training program for underwriters to recognize what we call red flags in the file. When you're calling a borrower's employment and they are not present, that's another red flag.

And so literally we looked at it by occupancy. If someone is buying a property outside of the marketplace and still intended to work there, that should raise a red flag. Well, how could this possibly be a primary residence if you're buying a house that's 200 miles away? Because we were not only looking at the income piece. We were trying to make sure that we understood who was the primary -- who is intended to occupy. Because one of the things we were really trying to weed out was the investment population.

CHAIRMAN ANGELIDES: Okay. I just violated my rule. Very quickly, did you have a set of written procedures in place for fraud detection?

MR. RUBIN: We had a credit policy, a written credit policy for all of our underwriters to follow. I don't recall offhand back three, four, five years ago if there was a specific fraud section.

CHAIRMAN ANGELIDES: Will you please provide us if you had any policies. And then, secondly, organizationally was this solely in the hand of the underwriters or was there any sampling or verification by a fraud detection unit who in a sense backstopped, trained professionals who actually know how to look for problems?

MR. RUBIN: Yeah. Each of our underwriters has the ability to refer. So in the cases that I just gave, they would turn it over to our fraud -- we have a specific fraud group that are experienced trained professionals that would take that and then do whatever is necessary.

CHAIRMAN ANGELIDES: How many referrals did you make?

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MR. RUBIN: So, as an example, today a thousand a month.

CHAIRMAN ANGELIDES: Today. I want to go back. I'm more interested in, you know, the period when the fuse is burning towards the explosion. What about the 2005/2007 period?

MR. RUBIN: I don't know.

CHAIRMAN ANGELIDES: Would you have records of that?

MR. RUBIN: I really don't know.

CHAIRMAN ANGELIDES: Okay. I would assume you would if you had a protocol and you had a reporting process. So perhaps we could ask you to provide that to us.

I'm over my time.

COMMISSIONER GRAHAM: Good. Thank you.

And I wish to thank this panel for their excellent contribution to our understanding of this problem. As I indicated, I expect that there will be some follow-up questions in writing. I appreciate your willingness to receive and respond to those.

It is now 12:30. We will take a 15-minute lunch break and we reconvene at 12:45.

Proceedings

CHAIRMAN ANGELIDES: And we'll be back with Indigestion in fifteen minutes. He's the task master.

(Recess was taken.)

SESSION 3

COMMISSIONER GRAHAM: I'll call the Commission back into session. The third and final panel for today will be on the regulation, oversight and prosecution of mortgage fraud. Again, it says in Miami, but we are going to be looking more broadly than that. As we have done with the two previous panels, when I complete your introduction, I'm going to ask that you stand and be sworn.

Our first panelist will be Mr. Tom Cardwell who is the Commissioner of the Office of Financial Regulations for the State of Florida.

Mr. Cardwell, thank you for being here today.

Next is Mr. Wilfredo Ferrer, the United States Attorney for the Southern District of Florida.

Thank you.

And, finally, Mr. R. Scott Palmer, Special Counsel in Chief of the Mortgage Fraud Task Force of the Attorney General's Office of Florida.

Thank you.

If you would please stand and raise your right hand.

Proceedings

Do you solemnly swear or affirm under the penalty of perjury that the testimony you are about to provide the Commission will be the truth, the whole truth, and nothing but the truth, to the best of your knowledge?

MS. CARDWELL: I do.

MR. FERRER: I do.

MR. PALMER: I do.

(witnesses sworn)

COMMISSIONER GRAHAM: Thank you.

One other item. I anticipate that we will not be able to ask as many questions orally as we would like and, therefore, we ask your indulgence if we had written questions to be submitted later.

All: Yes/Of course/That would be fine.

Thank you very much.

Mr. Cardwell?

MR. CARDWELL: Thank you.

Chairman Angelides, Vice Chairman Thomas, Senator Graham, Members of the Commission, my name is Tom Cardwell and I am the Commissioner of the Office of Financial Regulation in the state of Florida, a position in which I have served now for one year. Prior to assuming this position, I was a lawyer in private practice for longer than I care to comment with the Akerman Senterfit firm, a

500-attorney firm based in Florida, where I served as Chairman and CEO and headed the Financial Institutions Practice Group.

Relative to this appearance, I served on the

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Florida Supreme Court Mortgage Foreclosure Task Force which made recommendations to deal with the crisis in our Florida courts regarding mortgage foreclosures. And might I add, I have known Senator Graham for many years.

The Office of Financial Regulation has jurisdiction over the state-chartered banking industry, securities industry, mortgage brokers and other financial industries. We have 453 employees, a budget of $43 million with which to carry out our responsibilities for licensing, examination and enforcement in all of these areas.

The real estate mania or bubble that overtook much of the nation certainly manifested itself in Florida. As in almost every bubble, there are opportunities for fraud and those who will avail themselves of that opportunity and the mortgage industry was no exception. The events that led up to the mortgage foreclosure crisis in Florida revealed weaknesses in the statutory scheme and the regulatory execution of that scheme. There have been significant changes and improvements since that time.

Among the statutory weaknesses were that many

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persons engaged in originating the loans were not required to be licensed, and for those who were required to be licensed, background checks were only required at the time of the initial licensing and not on the renewal of licenses.

On the regulatory side, regulators were slow to implement federal criminal background checks and regulators were not as responsive to complaints and practices that they heard from the public as they could have been.

Florida has taken a number of steps to address these weaknesses. As you may know, on July 30th, 2008, the President signed the Secure and Fair Enforcement for Mortgage Licensing Act, the acronym for which is the S.A.F.E. Act.

Florida is in compliance with that Act and has in fact gone beyond its requirements. Florida now requires that all persons engaged in the mortgage origination process be licensed unless exempt. This addresses the issue of unlicensed persons dealing with the public.

Next, each licensee is required to meet a new strict standard that include passing a detailed criminal and credit history background,

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demonstrating professional competency by successfully passing national and state examinations and having the background checks repeated annually as a part of the license renewal process.

Further, the background checking process has been enhanced, and as one of the complaints was a number of unsavory characters that were allowed to participate in the mortgage business. Under new Florida law, all participants are required to have the yearly background checks and credit histories.

Now, individuals with certain credit -- criminal records are now barred from the mortgage industry and our license requirements are higher than those that are required under the S.A.F.E. Act. For example, in Florida any crime of moral turpitude can be a bar for participation, not just financially related crimes. In addition, Florida imposes the same background checks that S.A.F.E. imposes on individuals, on the officers and directors of the businesses with whom those originators were.

I think the S.A.F.E. Act is an important act. I think there are some fundamental changes that in both Florida and nationally will change the mortgage origination business. It will become much more professionalized. It will become better educated. I hope this will allow an increase in consumer confidence and there will be much stronger gatekeeping with respect to those criminal backgrounds. And I think these changes will go some significant way in addressing fraud in the origination process.

On the regulatory side, we have developed rules to implement the restrictions of those having criminal records from entering the business. We have tightened our procedures to make sure the applications are processed timely and completely. We have developed and implemented state-of-the-art software for regulating mortgage brokers that let's us make sure that any of the issues are less likely to fall into the cracks and to look at all the records in a single database which we were not capable of doing before.

Now, our agency does not have criminal prosecutorial authority; however, when a complaint leads to examination and fraud, we do partner with an agency that does, many of these here, and we are a resource to other agencies.

COMMISSIONER GRAHAM: Mr. Cardwell, if you would summarize.

MR. CARDWELL: I shall.

And I'd like to speak just very briefly about the world of mortgage regulation in the future. And to that I would say the financial crisis has framed the question to the regulatory community "What could we have done better?" And the challenges for all regulators I think are to get ahead of the curve.

It's the story of Wayne Gretzky. What he did, he would skate to where the puck was going to be and not where it is. And I think in regulation we have not done that as well as we should, and I think that is the challenge for us going forward.

I see that my time has expired, so with that, thank you.

COMMISSIONER GRAHAM: Thank you very much.

Mr. Ferrer?

MR. FERRER: Good afternoon, Ladies and Gentlemen of the Commission. My name is Wilfredo Ferrer and I've had the pleasure of serving as the U.S. Attorney for the Southern District of Florida

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for the last four months. I want to thank you for inviting me and I'm very pleased to be here to assist you in your fact-finding process.

As you know, the mission of the Department of Justice and of all the U.S. Attorneys’ Offices across the country is to enforce our nation's laws by investigating, prosecuting and punishing those who commit crimes, including financial crimes and fraud. And in this context, the Department of Justice and the U.S. Attorney's Office for the Southern District of Florida have waged an aggressive campaign to help stem the tide of mortgage fraud that has tarnished our communities and our nation.

But our prosecutorial efforts, no matter how aggressive and focused, are defined and limited by our role in the justice system, and our role is to bring to justice those who have committed or have conspired to commit fraud. Now, unfortunately, that often means that the fraud has already been committed and the harm has already been done by the time we become involved. Still, we believe that our prosecutions, and the resulting punishment, help prevent fraud by deterring others from

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committing similar crimes in the future.

Now, despite our District's increased scrutiny and continually rising prosecutions, mortgage fraud continues to be a serious problem in my hometown and here in South Florida. Earlier in the decade, South Florida benefited from tremendous growth during the real estate boom. But as a result, however, we were hit particularly hard with the market's eventual fall.

In 2009, for example, the Miami-Fort Lauderdale metropolitan area was ranked by RealtyTrac, the year-end report, among the top ten U.S. metropolitan areas for foreclosure rates, with 1 out of every 14 homes facing foreclosure proceedings. In addition, Fannie Mae ranked Florida number one in loan origination fraud in 2008 and number three in 2009. And according to FinCEN and the Department of Treasury, California and Florida led the nation in the number of mortgage fraud loan subjects reported in their Suspicious Activity Reports, also known as SARs, for 2009. In addition, the Mortgage Asset Research Institute, known as MARI, ranked Florida number one for mortgage fraud for the four straight years

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prior since 2006.

Recent figures estimate nationwide mortgage fraud losses for 2009 are approximately $14 billion. In addition to staggering losses, our cases reflect that mortgage fraud breeds other crimes. We continue to see mortgage fraud tied to other serious crimes, such as identify theft, money laundering, credit card fraud and even arson, just to name a few. The use of the Internet and related technology to receive and process loan applications is increasing and that makes the fraudsters anonymous and easier to hide.

Our prosecutions reveal that the perpetrators of mortgage fraud have infiltrated every level of the loan industry. We're talking from straw buyers who pose as legitimate purchasers to corrupt mortgage brokers, appraisers, complicit title agents, attorneys and bank loan officers.

Now, to address the mortgage fraud problem in South Florida, in September of 2007, our office, the U.S. Attorney's Office, announced its Mortgage Fraud Initiative. Then we built upon the success of that Initiative and we created a Mortgage Fraud Strike Force comprised of experienced federal

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prosecutors and state and local agents, officers and financial analysts dedicated exclusively to investigating and prosecuting mortgage fraud cases.

Using this model -- which, by the way, was a model for the nation -- of federal, state and local cooperation, law enforcement is working together, efficiently and quickly in sharing information and focusing on common goals.

Our Mortgage Strike Force has yielded substantial results. As of September 20th, actually yesterday, from the time we started our initiative in 2007, we have prosecuted 401 mortgage fraud defendants at all levels of the mortgage process responsible for almost half a billion dollars in fraud. And more recently, the Financial Fraud Enforcement Task Force, established in November of 2009 by the President, has helped shed a national spotlight and renewed multi-agency emphasis on mortgage fraud investigations and prosecutions.

This leads me to my final point. While prosecutions play an important role in deterring mortgage fraud, prosecutions are not the solution to the mortgage fraud problem. We can very well

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double our prosecutions and still not slow down the tide of fraud. Prevention, that is the real answer, and in that regard, private industry, law enforcement and regulators must join forces, communicate and coordinate to better prevent the fraud on the front end.

This is where the President's Financial Fraud Enforcement Task Force comes into play and it has its greatest impact. By educating the industry and law enforcement about emerging frauds, learning from victims at town hall meetings, educating the public on how to avoid becoming the victim of fraud, sharing lessons learned, and spearheading national projects like we did in June of this year which is called Operation Stolen Dreams, the Financial Crimes Enforcement Task Force provides a crucial tool to combat financial fraud.

Thank you very much for inviting me once again and I look forward to your questions.

COMMISSIONER GRAHAM: Thank you very much, Mr. Ferrer.

Mr. Palmer?

MR. PALMER: Yes, sir.

On behalf of Attorney General Bill McCollum, I

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wish to extend our thanks to the Commission for being invited here to testify about how the Florida Attorney General's Office has addressed the mortgage fraud problem in Florida. As you noted, I'm Scott Palmer. I'm special counsel to the Attorney General and I'm also head of an internal mortgage fraud task force. And I also teach at Florida State University Law School. I teach white-collar crime.

When I arrived back at the Attorney General's Office in 2007, mortgage fraud was already on the radar screen. Historically, the Attorney General's Office only has the authority to prosecute mortgage fraud civilly under the Florida Unfair and Deceptive Trade Practices Act. The Unfair and Deceptive Trade Practices Act allows the Attorney General to seek damages, penalties, restitution, dissolution and other equitable remedies.

Since the late 1980s, the Office of Statewide Prosecution has been indeed housed within the Attorney General's Office and they have the ability to pursue multi-jurisdictional cases that would involve the crimes that are involved in the mortgage fraud.

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Now, in the summer of 2007, we, the Florida Attorney General's Office, had a citizen services consumer hotline, and they began to receive complaints about something we call mortgage rescue fraud. They also began receiving complaints about questionable real estate deals and complaints about lenders.

As a result of these complaints, we formed our internal task force and we had to use investigators and attorneys that had actually other duties and volunteered to be on this task force. We triaged these cases and then we either prosecuted them civilly or referred them to local prosecutors criminally.

Now, I've described the most egregious cases that we found in my written testimony and I won't go over that here.

And another thing that we did is we did form a small unit to analyze various property transfers based on tips that we received in the citizens services hotline. And what we saw primarily were properties that were listed, for example, for $400,000 one day and then relisted for $600,000 the next day and then there was an immediate sale.

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Now, we used this type of information as information to open cases and to subpoena records from title companies and other various people to investigate these cases. One such suit that we filed is described in my written testimony as the American Heritage case.

We also of course received complaints about lenders. We received most complaints about Countrywide. Countrywide, we launched an investigation into Countrywide. We found out that Countrywide didn't even follow their own underwriting standards. They didn't follow industry underwriting standards. They placed borrowers into loans that they couldn't afford. They failed to properly disclose the loan terms. They placed borrowers in inappropriate mortgages and they compensated underwriters with bonuses that were based on volume instead of quality and all things I'm sure you've heard before.

At same time that these civil prosecutions were pending, our Office of Statewide Prosecution was also prosecuting cases criminally. And I think Agent Wilcox mentioned the Argent Mortgage case and that was one of the cases and many others

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prosecuted by our Office of Statewide Prosecution.

One of the things we discovered was shortcomings in our laws. First, realtors and appraisers couldn't be included in our civil suits because under the Unfair and Deceptive Trade Practice Act, they were statutorily excluded on the theory that regulatory agencies needed to take corrective action against them. Sometimes they did and sometimes they didn't.

Second, even though the Attorney General had the power to investigate and file civil racketeering cases, the proceedings were basically under state law in rem proceedings. They had to be filed against property. The cases that we were looking at, the property has been dissipated, and under Florida law, you didn't have a racketeering case because you had no property to file against. Under federal law, the civil racketeering -- you can file a civil racketeering case against the person and then seize substitute property, and that's not the case in Florida law. So our hands were tied there.

And of course in the Countrywide case, that was taken over by Bank of America. Under Florida

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law, we can't investigate federally chartered banks, so we had to file suit against Countrywide the day before they were purchased by Bank of America. Otherwise, we would have lost the entire case.

Now, we accomplished some statutory reform, and with the passage of the Florida Statute 501.1377, we basically made it illegal to take any type of up-front fee in any kind of mortgage modification. And that pretty well shut down the business.

Also, as Mr. Cardwell has noted, under the S.A.F.E. Act now, a mortgage -- any type of mortgage modification person has to be licensed under the State of Florida. And those two things have really brought down the incidence of mortgage risk and fraud.

Also, in response to the fact that our laws have shortcomings, we formed an inter-agency task force which put together the Attorney General's Office, the Office of Financial Regulation, the Florida Department of Law Enforcement and other local law enforcement agencies so we could triage cases and refer them appropriately.

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And I see I'm out of time. But what I would like to say also in closing is that mortgage fraud is a very unique crime, because in most instances the victims are also the perpetrators and the perpetrators are the victims. Those who are the victims of the mortgage rescue scheme invariably commit the serious felonies of misrepresenting the assets or other things when they obtain the mortgage in the first place.

Lending institutions that suffered these unfathomable losses were often guilty of predatory lending practices and sometimes even encouraged the commission of felonies beseeching mortgage brokers to write mortgages through any means necessary so that they would have a portfolio to sell on Wall Street.

COMMISSIONER GRAHAM: Would you summarize please.

MR. PALMER: Yes.

And mortgage brokers and others were also involved.

So in case, in closing, the recent dramatic increases in the private criminal prosecution of mortgage fraud perpetrators at all levels is

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commendable and necessary. But I agree with the U.S. Attorney in that the best way to do it is to develop systems that will detect mortgage fraud at the time it's occurring and not prosecute people after it has occurred.

Thank you.

COMMISSIONER GRAHAM: Thank you very much.

In one way or the other, you've all touched on the issue of prevention as being the superior strategy to chasing after the event. From your experience, what have you found to be the most effective measures, either using government regulatory enforcement measures or using the marketplace? What have been the most effective preventive tactics against mortgage fraud?

MR. PALMER: The most effective preventative tactics revolve around having sufficient intelligence about what's going on and then acting quickly to stop the problem. A criminal prosecution --

COMMISSIONER GRAHAM: Pull your mic --

MR. PALMER: Oh, I'm sorry.

A criminal prosecution takes a long time to develop. You can hit -- if you develop a case that has -- that you can prove, say, to the preponderance of the evidence instead of beyond and to the exclusion of every reasonable doubt, you might be able to go in and hit the people in frauds with a civil injunction to stop the activity from occurring and then refer it for criminal prosecution. And that's what we were attempting to do.

COMMISSIONER GRAHAM: Mr. Ferrer, any thoughts on what you found to be effective preventive tactics?

MR. FERRER: I think that what we are doing now nationwide with the President's Financial Fraud Enforcement Task Force, that is a great example of an effective prevention tactic, and that is because we are now elevating the problem nationwide. In June of this year, we announced the takedown on Operation Stolen Dreams where in a three-month period here in the Southern District of Florida, we indicted 86 defendants who were responsible for $76 million in fraud, in loans that were issued by fraud.

By elevating that, having press conferences, every time you have a mortgage fraud case, we issue a press release letting the public know what the schemes are that we are seeing and how to prevent it and what to look out for.

I have also just -- I've been on the job for four months. Two weeks ago I went with the Assistant Attorney General, Tony West, to the National Hispanic Prosecution and Bar Association nationwide, and we talked about mortgage fraud in a panel. And what I think is very effective is when the regulators sit down with us and they hear from us as to what we're seeing in our cases so that they see lessons learned, in other words, and know what to look out for from here on into the future and what we're seeing in our cases. And I think that's been very effective.

COMMISSIONER GRAHAM: Mr. Cardwell?

MR. CARDWELL: I think this panel touched on the most important aspect of prevention earlier this morning. I think that the incentives in the system to create frauds are the most pervasive and serious problem. A bubble is an incubator of fraud. It really starts with that. Whenever you have an economic bubble like this, it is going to attract people into fraud. If the money is there, the people are going to be there.

In my experience, I saw the amount of money poured into the housing market by the banks and investors. I saw the lax lending standards. I saw the lax of accountability throughout the system that you all discussed this morning. I saw out-and-out greed. I saw economic illiteracy by a number of people. And all of those created, if you would, here in South Florida a perfect storm to have a great deal of fraud. And while we as a regulator can help by controlling who gets into the industry and while Mr. Ferrer and Mr. Palmer can work on prosecuting it, those are in the sense activities that we all engage in that are shutting the barn after the horses have fled.

And so if the topic is prevention, I firmly believe that you're going to have to deal with the market incentives and policies which create conditions in which fraud is rife.

COMMISSIONER GRAHAM: Mr. Ferrer, I am going to raise a somewhat sensitive topic, but you referred to the fact that you had recently attended a meeting of Hispanic prosecutors. Is there anything about this issue that is different in a community such as this one with a high degree of diversity vis-a-vis a community that is more homogeneous?

MR. FERRER: Actually, what I have seen, Mr. Commissioner, Senator Graham, is that because of the diversity that exists in the Southern District of Florida, we fall -- the population here is more vulnerable. I have seen one of the cruelest schemes which is when two defendants went after the Haitian-American community purportedly for immigration services and they asked them to come forward to get assistance in their immigration proceedings, their housing, government programs. And what they did was they stole their identities. The fraudsters took advantage of language barriers, cultural differences, the fact that they were in need of other services, and they stole their identity, and then they got mortgages based on those stolen identities and then they sold homes and flipped them based on the identities of these victims.

I think that in a population of diversity, which is our greatest strength, also makes it very vulnerable and fraudsters to come and take advantage.

COMMISSIONER GRAHAM: Mr. Ferrer, I'd like to pursue something that was said at the first panel, and you eluded to it in your remarks, and that is the level of prosecution. It was stated that while there were a thousand or more people prosecuted as a result of the Savings and Loan Crisis of 20-or-so years ago, that there have been no prosecutions during this current financial crisis.

Now, you indicate and I think you gave the number of 401 cases. Is that correct?

MR. FERRER: Yes, Senator. Yes.

Actually, that could be -- I mean, at least in this district, that could be no further from the truth. I mean, we actually in the last three years alone from 2007 when we started our Initiative until yesterday, we've prosecuted 401 defendants who were responsible for almost half a billion dollars in fraudulent loans.

Mortgage fraud is not new to our district. We have been prosecuting these cases since the beginning of the decade, even beforehand. In 1999, for example, just as a quick example, we brought down a substantial case. It was called Operation

Flipper and it involved 250 properties, more than that actually, more than 250 properties, that were illegally flipped. And we did that in 1999. That was a 19-month investigation. Nine defendants. They were responsible for $36 million in fraud. And then we had Operation Flipper Part 2 in 2001 which involved more than 50 properties.

So we've seen the fraud here in South Florida and our office has effectively and aggressively prosecuted those cases. So -- and I will also tell you that there is expected more to come. We have pending investigations as do the law enforcement agency that we work with.

COMMISSIONER GRAHAM: In that same panel, there was a lot of discussion about what is referred to as control fraud, which is where the institution, such as a mortgage originator or a bank, is part of the fraudulent activity by allowing conditions to exist which promote fraud.

Have you seen here in South Florida evidences of this so-called control fraud, fraud from the top of the financial food chain?

MR. FERRER: Well, the way we work our cases is that we follow the evidence wherever it leads

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us. What we have found so far in the Southern District of Florida is -- and we have prosecuted insiders from the bank, from the financial institutions, such as bank managers, loan officers and the such.

Again, this is an area where we are continuing to investigate. We will always follow the evidence. We have in the past on other matters -- this month -- I mean, this year, for example, on Wachovia, you remember that we filed an Information against the bank for not having an anti-money laundering program.

So we are following the evidence, and right now what we have brought so far to date have been bank insiders, such as managers and loan officers, but not institutions.

COMMISSIONER GRAHAM: Mr. Palmer, you indicate that in Florida, the Attorney General can either directly prosecute mortgage fraud and the similar cases or can refer it to a local State's Attorney for prosecution. Did I hear correct?

MR. PALMER: We can civilly prosecute.

COMMISSIONER GRAHAM: You can not criminally?

MR. PALMER: We cannot criminally prosecute.

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That can only be done by either the statewide prosecutor or the local State Attorneys.

COMMISSIONER GRAHAM: Do you know how many referrals you have made for criminal prosecution of mortgage fraud to either State's Attorneys or the statewide prosecutor?

MR. PALMER: I don't have a number with me, but I'll be happy to provide that.

COMMISSIONER GRAHAM: All right. You also suggested that there might be some further changes in the Florida law which would facilitate prosecution of these cases.

MR. PALMER: That's correct.

COMMISSIONER GRAHAM: Maybe in written form could you give us what you think some of those changes should be.

MR. PALMER: Certainly.

COMMISSIONER GRAHAM: Mr. Ferrer, you mentioned SARs reports. In the -- again, in that earlier panel, a statement was made that only one-third of the persons who potentially might become aware of a suspect activity were today covered by the SARs statute, whereas I guess banks that are under some regulatory regime, their

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employees are required to report suspicious activities. But if you are a mortgage broker and you see suspicious activity, I believe they are outside the SARs net.

Is that a serious issue in terms of your ability to get eyes onto the activities that may be a precursor of fraud?

MR. FERRER: You're correct, Senator. My understanding is that SARs, only banks files these SARs.

However, I do want to point out that we get cases referred to us from many, many sources. We have victims, bank insiders who cooperate with us. Even defendants sometimes will come forward to reduce their exposure. Other brokers who will give us information about others who are committing crimes. So we get referrals from all different types of sources. And even -- and we welcome any opportunity or any changes that would, you know, bring us more referrals.

COMMISSIONER GRAHAM: Do you think that the SARs law should be amended to widen its applicability?

MR. FERRER: Well, I wouldn't happen to have

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the expertise, I'm sorry, Senator, to opine on that.

COMMISSIONER GRAHAM: I will accept that, although I respect your judgment and opinion and maybe we might pursue that.

MR. FERRER: Absolutely.

COMMISSIONER GRAHAM: Mr. Cardwell, under the new laws at the state and the federal level that have passed relative to mortgage brokers, what's your assessment of the current level of enforcement of those inside Florida? Are we doing a better job of ferreting out the charlatans and those who should not be preying upon our people?

MR. CARDWELL: Yes, we are.

In terms of timing of that, the actual systems of implementing -- and I won't go into the details of it -- but really take effect on October 31st of this year. And then beginning the 1st of the year, the changes that were passed -- the 2008 federal legislation came into effect. In 2009, Florida passed the implementing of legislation. 2010 it's actually being implemented.

I expect that we will be able to do this seamlessly. I expect this to have a strong salutary effect on the mortgage origination business, because you're going to have to significant educational requirements to get into the business or you're not going to be allowed to interact with customers directly. And we're going to have extensive criminal background checks frequently followed up. And I have no -- we obviously have no statistics on this yet, but I truly think it is going to professionalize this business.

During the run-up of the problems that we have now, everybody and their brother got into the business. They raced to it. Our statistics show that applications -- that the number of active mortgage brokers in 2002 in Florida was 30,000 plus. And by the 1967, it was 81,000 people had become active mortgage brokers in the state of Florida. And a lot of that was probably people who should not have been in the business.

So I think that the S.A.F.E. Act implementation of that will have a very positive effect on getting a -- what's the right word to use -- a more professional grade of person in the business.

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COMMISSIONER GRAHAM: Let me ask one last question. Do you -- some of the regulatory agencies in Florida are self-financing; that is, those persons who are regulating pay are what support the activity of the regulatory agency.

Is that a case with mortgage brokers?

MR. CARDWELL: Having been the former Governor of the state of Florida, you may know the answer to that. The answer is that the fees that the industries pay go into trust funds which are for the purpose of executing that regulation. I would have to say in full candor that occasionally the legislative process has been known to reach into those trust funds, and so we do not always have the full benefit of the fees that that industry has paid in self-regulation.

COMMISSIONER GRAHAM: I won't ask you to answer this question today, but my concern is that as we increase the standards of enforcement, we're likely to drive down the number of people who are in the industry as those who shouldn't be are exiting. But those new enforcement standards have a dollar assigned to them in terms of what it costs to implement; that we could have strong standards on the books with strong enforcement, but if we don't have the resources to make them real, we have created another form of fraud on the people.

So I would like maybe to ask you by written question to give me some assessment of how financially capable the agencies are going to be to carry out this new responsibility.

MR. CARDWELL: All right. I shall do that.

COMMISSIONER GRAHAM: The Vice Chair has got some other commitments and has asked if he could go second, and after a long period of consideration, I have decided to grant him that request.

The floor is yours, Mr. Thomas.

VICE CHAIRMAN THOMAS: Thank you very much. And I will only take my time and maybe even less.

I guess I can find this out in another way, but since we've got Floridians here that understand the way in which your government is structured and the state governments are structured in a lot of different ways.

Mr. Cardwell, the jurisdiction of the Office of Financial Regulation, frankly from a Washington point of view, would be envied because you do have a degree of scope. You indicated that there were

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some activities not under you, but my gosh, you've got a good cross-section.

Is the Office of Financial Regulation under the Governor?

MR. CARDWELL: Independent. It's an independent agency.

VICE CHAIRMAN THOMAS: It's an independent agency.

MR. CARDWELL: The head of which is appointed by the four elected state officers.

VICE CHAIRMAN THOMAS: Oh, okay, okay. I'm familiar with that model on other arrangements.

And, Mr. Palmer, obviously the Attorney General is elected separately. But you indicated a coordinated effort with the Office of Financial Regulation.

MR. PALMER: That's correct.

VICE CHAIRMAN THOMAS: Let me ask Mr. Cardwell first, because he's been around longer. How is the coordination ordinarily between independent agencies and key state government functions like the Attorney General's Office normally carried out versus the current arrangement? Is that more personalities or is it a function of jurisdiction or the scope of the problem that you're trying to deal with?

MR. PALMER: I think --

VICE CHAIRMAN THOMAS: You can't choose all of the above.

MR. CARDWELL: Right.

I think there is no formalized structure by which coordination is implemented. We have very good working relationships both with the Attorney General's Office, with the federal offices as well. It is a matter of initiative. In this particular area of mortgage foreclosure, there has been a lot of cooperation, and I will say in part because of the heat of the issues that have been raised.

VICE CHAIRMAN THOMAS: I was a little surprised at your example in terms of what you ought to do versus what happens using the great one and an ice hockey illusion in Florida. Talk to most duck hunters and they'll tell you if you shoot at the duck, you won't be having duck for dinner. You'll have to lead them.

My only problem is with decades of experience -- and I'm sure the Senator will reinforce it -- normally when you have government go in and examine, it is a reaction and not an action. And what government would have done, it would have been gone to the ice hockey player who initially struck the puck that was on its way rather than try to go to where it's going to go. And I think that's frustrating among a lot of us and I've heard those comments that it's much better to get out front and try to prevent the potential for fraud rather than trying to move back through the structure, detect it and then carry out some kind of law enforcement initiative.

I'd love to hear your idea as to how you do that, especially if it requires laws passed by a state legislation or Congress. It's tough enough to get them to pass laws on a reaction basis let alone in an anticipation basis.

MR. CARDWELL: I think it's an institutional framework. In our office, we have started asking the question, What do we see coming down the road?

A quick example with the loan modifications, we saw people who had been originating the loans, then turning around and going into the loan modification business with the same loans that they had originated were failing. And we put together a task force at the beginning of this year internally to look at it. We've issued a number of cease and desist orders. We have also, in addition to that, tried to publicize these. We've gotten the media in with us so that people would know that this is going on.

There is no statutory formula for it. We sit at staff meetings and say, What do we see coming up next? It is extremely difficult. I think in my view, the recent passage of the Financial Regulatory Reform Act with respect to its systemic risk approach, however that works, is an idea that gives -- is an attempt to flush out, pushing regulators into a place where frankly, you were correct, they're not always very comfortable.

VICE CHAIRMAN THOMAS: Well, and historically it's been so divided and broken up, I would think that your ability to sit and think about what's next is in part due to the scope of activities covered by the Office of Financial Regulation in Florida that may not be available to many others.

I want to ask a question just because I'm not from Florida. I do recall having gone through an earthquake in California, getting on an airplane

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and then landing at Dulles and surprised to find that there were cameras and interviewers asking the passengers getting off the plane if they were going to go back to California. Because after all, the earth moved in California, and of course those of us who grew up getting knocked out of bed from earthquakes not very frequently wondered why people on the east coast would ask that question when they not only get knocked out of their beds, especially in this area of the U.S, but get knocked out of their homes on a fairly periodic basis. And of course Florida in recent years suffering massive and repeated damage.

So here's my question: Did anybody detect any of this mortgage fraud over those periods through insurers or others who were dealing with fairly significant disruptions in the housing market both in terms of sales, damage, insurance activities? Did anyone look at any of that and was anything evident from some of the patterns?

MR. CARDWELL: I am not aware of those patterns being there now. Remember, I was in another place and a regulator at the time. But what I think what we all saw is what everybody saw in the nation --

VICE CHAIRMAN THOMAS: But what did you know and when did you know it, I guess?

MR. CARDWELL: Right.

I think we all knew that there was a tremendous growth in housing values and that none of us wanted to admit -- and by us, I mean the public at large beyond the regulatory community but certainly within it -- that this potentially was going to be a problem. We heard the same talking heads on TV and all that things are going to be all right. And we would walk around our own streets and say, I can't believe that anybody would pay that amount for that house.

Now that I'm a regulator, one of the things that I have come to realize is that one of the hardest things to do is to recognize the nature and extent of a problem while you are in the middle of it. The retroscope is a wonderful device, but that's really the best answer that I can give to you.

VICE CHAIRMAN THOMAS: I know it's difficult, but you need to know that in our New York hearing, we asked much the same question of someone who has a reputation of being ahead of the curve, Warren Buffet, and he said that they hadn't anticipated; that obviously there's books out now with the very few who were swimming against the stream, but that's why there is a book out about it, because there were very few of them.

Obviously some areas in California have been similarly hit. I do think that the scope of your ability to look at an industry and not look at it segmentally is very valuable, and I'm going to take a look at what you've done in Florida and see if we can try to create some structure. Because frankly, in the long-run, creating task forces after the fact simply isn't going to deal with this issue. And although a lot of us like to think that this won't repeat itself, you've been around long enough and I'm beginning to have been around long enough in California to note that as well. We just hope that we learn from this particular crisis, because there are an awful lot of people out there who are hoping that it doesn't happen again.

Thank you, Mr. Chairman.

COMMISSIONER GRAHAM: Thank you very much, Mr. Thomas.

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Ms. Murren?

COMMISSIONER MURREN: Thank you, Senator Graham. Thanks to all of you for being here today.

I wanted to follow up on some of our questions earlier specifically relating to how it is that fraud cases or instances of fraud come to your attention.

And I think, Mr. Ferrer, you had eluded to it in your commentary, but I wonder if you could also comment on how it is that you make determinations about which cases you will advance. Do you have an obligation to look at each one of them as they come in, and then at what threshold do you use to make decisions about that going forward?

MR. FERRER: Yes, Madam Commissioner.

As I said before, we get our cases from a variety of sources, from our law enforcement partners, in other words, federal law enforcement agencies that are reviewing and looking at these cases, our state and local partners as well. We've created a federal and state law enforcement task force. So that's how we get a lot of the referrals.

In addition, as I said before, victims, folks who are left with a home that they can no longer afford, now they look back and realize that the appraisals were artificially high. We get referrals from insiders from the industry who want to cooperate with us and expose some fraud.

And when the cases are referred to our office, first they go to the agencies that are the investigative agencies and they start an initial investigation. Once that's ready to be presented to the U.S. Attorney's Office, they come to us. We have a procedure, and I like to call it a flexible intake procedure, and we look at it case by case. Because we want to make sure with our resources that we have that we put the -- that we prosecute the matters that make the best use of resources and have the greatest impact in our community in terms of punishment, deterrents and then education. Which goes back to the prevention question from Senator Graham, what of those kind of cases are going to have the greatest impact given what we have to work with?

Then we look at to see also the types of cases, the nature of the victims, the types of targets. What are the roles of those targets in the industry? Are they insiders? That's going to make a case much more impactful.

Safety is something that we look at. You know, as I said in my testimony, these crimes breed other crimes. We had a case where there was arson, attempted arson, where there were two public adjusters who saw a house under water and decided that they were going to just torch the house and then file false insurance documents. Thankfully we were able to thwart that. Those are the kind of cases that we jump on first.

We also prioritize by looking at cases that are fraud-for-profit and opposed to fraud-for-property. Fraud-for-profit are those who are basically flipping the properties just to line their pocket. There's no intention of living there. There's no intention of paying the mortgage.

The fraud-for-property are those single-mortgage cases where someone does lie and commit fraud, but they really -- they intend to live in the property and intend to make the mortgage payments. That's still illegal, but because of our resources, we focus more on the fraud-for-profit.

There is no threshold amount to answer your last question.

There are cases -- again, it depends on -- fraud amount and the loss is a factor. It is a factor, but it is not the only factor. And so we have cases ranging from thousands to over a million dollars.

COMMISSIONER MURREN: So you do feel that for people that may not have a huge dollar amount associated with being victimized by fraud, that they still have some resource in the system as it's currently received?

MR. FERRER: Absolutely.

I would tell them, Come forward, call us. The beauty of having a federal state task force is that if a case is better suited to go to the state, we will do so. And if it's better suited to come to the federal authorities, we will do that as well.

COMMISSIONER MURREN: Mr. Palmer, would you like to add anything to that?

MR. PALMER: Well, just that the Attorney General's Office is in quite a different position because we prosecute cases civilly. And so what we look for is cases where a civil suit or an injunction would make an immediate impact and stop the illegal activities. We have very few -- very limited resources available to do this. We have had as many as 5,000 complaints in a single week regarding mortgage fraud, and we don't even have the personnel to read them all or to analyze them all.

We once applied for a $6 million grant with the federal government to try to beef up our Mortgage Fraud Task Force and that was declined. So we're a little bit under the U.S. Attorney's office.

COMMISSIONER MURREN: In your testimony though you mentioned as a result of a change in the regulatory structure as it related people being able to engage mortgage modifications, that there was a significant decline in complaints --

MR. PALMER: There was.

COMMISSIONER MURREN: -- after that was passed.

Do you see other opportunities for that type of action or do you feel like the current state of the regulatory structure is where it needs to be?

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MR. PALMER: With the type of criminal activity that has been going on, the state of the regulatory structure is where it needs to be right now. But, you know, the past is not much of a predictor of the future, so I don't know what's going to happen.

COMMISSIONER MURREN: To follow up on the cooperation between the various agencies and regulators, some of the commentary that we've heard previously from people who have testified relates to either an inability to cover all of the ground that needs to be covered because of the way that the different agencies may be siloed in terms of their authorities or an inability to cooperate because of barriers to communication.

Do you feel like the federal and the state laws and regulations are currently covering all of what needs to be covered or do you feel like they present any kind of impediment to you being able to do your jobs and do you feel like they did at any point in time in the past?

MR. PALMER: Well, as far as state and federal laws to prosecute mortgage fraud, I think we have more than enough laws; fire fraud, mail fraud,

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theft, racketeering. I don't think we need more laws to be able to prosecute mortgage fraud. What we need is more resources.

In my interactions with other agencies, the only thing that has been a limiting factor really is not their ability or their desire to prosecute cases or to take cases forward. It's been a matter of resources.

COMMISSIONER MURREN: Mr. Ferrer?

MR. FERRER: Yes, I agree with Mr. Palmer in terms of the laws. We've been very successful actually using the laws on the books. And, actually, we have now more tools, because last year the Financial Enforcement Recovery Act of 2009 gave us more. The Statute of Limitations in wire and mail fraud cases that deal with financial institutions went up. Statutory maximum penalties for wire fraud and mail fraud cases dealing with financial institutions also increased from 20 to 30 years. I think we're well equipped in that sense.

Resources, I would welcome more resources, because we just have so much of mortgage fraud here in South Florida. But we've been successful. We have in our office dedicated more than a quarter of our economic crimes Assistant U.S. Attorneys just on mortgage frauds. And, remember, we're also in addition to mortgage fraud -- and Senator Graham I'm sure knows this. We're also the healthcare fraud capital of the country.

So we're stretched thin. We're working very hard. And I know that the President's budget is asking for more. They're asking for more Assistant U.S. Attorneys to deal with white-collar crimes and more FBI agents to deal with white-collar crimes. So I hope that this goes through.

COMMISSIONER MURREN: Just one final question for Mr. Palmer. You had mentioned in your written testimony that no category of perpetrator should be ignored.

MR. PALMER: Yes, ma'am.

COMMISSIONER MURREN: Is there one that you feel is being ignored?

MR. PALMER: If there is one that's being -- well, I think there may be some ignoring from the prosecution of straw buyers, the people that initially fill out the applications for the fraudulent loans. And then when you get up the chain, if there has been bank involvement, for

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example, in soliciting these loans or soliciting felonious types of applications, I think those aren't being looked at.

COMMISSIONER MURREN: Thank you.

COMMISSIONER GRAHAM: Georgiou?

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman.

Mr. Cardwell, obviously there's a focus in your testimony -- it almost goes without saying -- that ex-felons previously convicted of financial fraud ought not to be permitted to originate mortgages. But I think that is really two steps too low a bar, if you will, for the review of people in that business. And, you know, your reference to Wayne Gretzky, obviously not too many public official regulators have the skill of Wayne Gretzky to know where the puck is going to be rather than where it is.

So I've been focusing to some extent on this -- in these hearings on trying to identify the lack of market discipline and accountability that may have contributed to the financial crisis, and in this particular hearing to the generation of mortgage fraud.

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You were the General Counsel of the Florida Bankers Association. You spent your private career in Akerman Senterfit, which is one of the -- I guess the largest firm based in Florida. You were its Chair and CEO. So you had a full variety of experiences in the private sector. And without asking you to disclose any confidences with your clients, can you tell us what particular areas you think that the person who actually financed these loans, who enabled the money to be available for mortgage loans, failed in their duties to avoid the generation of fraudulent loans?

MR. CARDWELL: It's a very-good and it's a very broad-and-difficult-to-answer question. I heard I think one of our speakers earlier this morning talk about the topic that the attitudes and the ways in which large organizations behave themselves comes down from the top. And I think from my outside view, not having been in any of these large corporations, a willingness at times in some fairly public examples to tolerate or to turn, if you would, a blind eye to practices which, even if not strictly illegal, bordered on conduct that most of us, perhaps at another time, had said, as my mother used to tell me, decent people don't do that.

I think that the market --

COMMISSIONER GEORGIOU: And what would that be? Could you identify a couple of them.

MR. CARDWELL: I think that it comes -- I don't know that I have a specific example. But the idea of the drive for short-term profits is whether the discipline, the underwriting discipline, would be an example of the sort of thing where it has been very difficult in the banking industry --

Well, let me give you an example of a problem that I don't know the cure for, but it touches on this. Bankers have told me that they've been lending in the commercial real estate area for a long time. The long-time customer would come in. They would look at the loan and they would say to them, you know, This isn't a good loan and this project doesn't look good and I'm not going to loan you the money on it. So the person would go down the street to the banker down the street who might decide to make the loan, and it was essentially what some have described as a race to the bottom.

And none of the loans were illegal. They were

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matters of a judgment call. But the interest that people had to gain, the economic benefit of making the loan, perhaps turned a blind eye to the risks that were involved. That's what I'm trying to articulate.

COMMISSIONER GEORGIOU: Understood.

But of course it's really not in the interest of a lender to make a loan that's not likely to be paid back, is it?

MR. CARDWELL: As an abstract statement, that is one hundred percent true. Sitting with a borrower in front of you, sitting with a possibility of getting a loan origination fee at the front end of it, considering the possibility that you may sell the loan off, considering the fact that maybe you can really talk yourself into the fact that one more hotel down the street is going to work.

COMMISSIONER GEORGIOU: Right.

MR. CARDWELL: And what I've seen is people talk themselves into it.

COMMISSIONER GEORGIOU: Right.

But of course part of the problem is that the negative consequences of the failure of those various loans and the securities built on them, really the system didn't visit those consequences on any of the participants who were incentivized to originate them, but without really financial consequences to themselves for their failure.

MR. CARDWELL: I would agree with you.

COMMISSIONER GEORGIOU: Yeah.

And of course we took that all the way up to the institutional aspect where the institutions that sent -- in many institutions that failed as a result of either originating or purchasing products that turned out to fail ended up having their own failures, you know, having been cushioned from the otherwise market impact that their failures would have on their financial future. And I wonder if there is any particular area -- any other areas that comes immediately to mind that your former clients, if you will, took responsibility for their role in this process.

MR. CARDWELL: Well, I don't think I'm in a position to talk about my former clients in here.

COMMISSIONER GEORGIOU: Yeah, I don't mean -- I guess that's probably -- that was an unfair question. I didn't mean to identify particular clients. But as a general aspect of the industry, have you had any discussions where bankers felt that they -- you know, that they a role in the permission of this mortgage fraud epidemic that we found in South Florida and elsewhere?

MR. CARDWELL: I have never been a part of a conversation in which anybody confessed. As you know, confessions are very rare in life. And having been a lawyer, you have for many years, very few people on the stand say, you know, I did it.

COMMISSIONER GEORGIOU: Yeah, I agree.

Well, I think maybe I should turn back to the prosecutors and see if I can -- I want to commend both of you for all your work. I mean, we had an opportunity, U.S. Attorney Ferrer, to hear also from the U.S. Attorney of the district of Nevada, Daniel Bogden, the week before last on the extensive prosecutions there. And these prosecutions are extraordinarily important.

And I guess I would highlight and ask Mr. Palmer to continue the focus up the chain. It seems to me that if we are to have a deterrent effect from these prosecutions, it really has to -- you really need to follow the prosecutorial leads all the way up to the people who enabled them really,

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and I wonder if you could describe, you know, where are the highest levels that you're reaching in your prosecutorial discretion, at this point?

MR. FERRER: Well, at this point, as I had stated before, we've gone pretty high up. Just last week, I think it was -- oh, last month -- I'm sorry -- we indicted one of our first commercial loan mortgage fraud cases. That's the new -- that's one of the emerging schemes. And there was a loan officer who was involved, and a CPA as well, for $12 million that was fraudulently and deceptively -- Wells Fargo was deceived and the y issued a $12 million equity line.

We've gone up the chain. We have indicted straw buyers, brokers, real estate agents, bank managers, and loan officers, as I stated before. So we've -- we're prosecuting cases up and down the line.

COMMISSIONER GEORGIOU: Mr. Palmer, did you hear the earlier testimony of Mr. Black about control fraud?

MR. PALMER: Yes, I did.

COMMISSIONER GEORGIOU: Were you here for that?

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MR. PALMER: I heard part of it.

COMMISSIONER GEORGIOU: And what's your view of what impact control fraud had in the mortgage originations here in South Florida?

MR. PALMER: Well, I think it had a substantial impact on it, because the motivation for issuing these mortgages was the immediate sale and securitization of the mortgages, and I don't think that anyone in the organization really cared whether the mortgages would be paid back or not. I know I heard what you just said. It's illogical that you would issue a mortgage that wouldn't be paid back. But under the system that was here in 2006 and 2007, it was entirely logical to issue mortgages that weren't going to be paid back, because they were going to be immediately sold to Wall Street, securitized and resold again misrepresented along each chain of distribution.

COMMISSIONER GEORGIOU: Thank you. Thank you for your participation today.

COMMISSIONER GRAHAM: Mr. Chairman?

CHAIRMAN ANGELIDES: Yes, thank you, Senator Graham.

So let me start with this: If you look at the historical record, there were a number of warnings, indications that mortgage fraud was on the rise. Clearly, nationally and in regions across the country, the number of Suspicious Activity Reports rose dramatically from 2000 on.

In 2003, MARI surveyed its members, and of the respondents, 60 percent said they saw a moderate to significant increase in mortgage fraud.

FinCen, in April of 2003, had issued a Notice of Proposed Rule Making to subject title attorneys, realtors, mortgage brokers -- title companies -- excuse me -- realtors, mortgage brokers to SARs reporting.

In 2004, of course, there is a warning by Assistant Director for Criminal Investigations, Chris Swecker, that mortgage fraud has, quote, the potential to become an epidemic.

In 2005, the warnings continued.

In 2006, MARI delivers what's its eighth report to the Mortgage Broker Association indicating that, quote/unquote, competitive forces were leading to a greater use of products that had a potential for fraud.

In May of 2006, MARI does a sample of a

hundred loan files and finds that 90 percent have their incomes exaggerated by 5 percent, but more troubling, 60 percent had their incomes exaggerated by more than 50 percent.

Now, I want to ask each of you, in the light of all these warnings, Mr. Ferrer, you were at the U.S. Attorney's Office, and particularly in the light of the warning in 2004 by the FBI's Assistant Director, what did you guys do to respond, amp up your efforts, in a sense move to where the puck clearly had moved?

MR. FERRER: Yeah. First of all, in 2004, I was in the office. I was working on healthcare fraud cases and then I moved on to public integrity. So, unfortunately, I wouldn't be aware as precisely of what we were doing in mortgage fraud cases in particular.

However, I will tell you this: As I said, mortgage fraud is not new to South Florida. We have been systematically and aggressively prosecuting these cases. We did it in 1999 with the case I mentioned, over 250 properties. We did it in 2001 in another major case. What did change, again from our perspective, because we're -- it's

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frustrating because we're at the end of the game. You know, we get the cases after the fraud has been committed.

What we saw is a dramatic increase in the referrals of cases which started in 2007, and at that point, we responded to the number of increases in the level of fraud and the number of cases referred to us; therefore, we created the Initiative in 2007. Then the office built on that success and created the Federal State Mortgage Fraud Task Force in 2008. And so, in other words, our office has responded to the cases that's been referred to it.

CHAIRMAN ANGELIDES: Could you do this for me, would you please go back and as part of a follow-up to the Commission --

MR. FERRER: Yes.

CHAIRMAN ANGELIDES: -- indicate what steps were taken in 2003 on before the 2007 step that you referred to.

MR. FERRER: Glad to.

CHAIRMAN ANGELIDES: Mr. Palmer, were you at the AG's Office during that time frame?

MR. PALMER: No, I wasn't. I was happily in

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private practice during that time.

CHAIRMAN ANGELIDES: Have you done any assessments in the Attorney General's Office in terms of that time frame and what the office did do, should have done, might have done?

MR. PALMER: No, I have not.

CHAIRMAN ANGELIDES: All right. And I guess, Mr. Cardwell, I know you're new to it. But as you came in, obviously there was significant changes made, not only federal legislation, but then the state licensing legislation.

Did you do a retrospective examination of your agency to look at how it did or did not respond and why it did or did not respond to the rise of mortgage fraud?

MR. CARDWELL: Nothing formal in the sense of any kind of formal study in there. I think in our case, we are not a prosecutorial agency. What we did do was see a rise in complaints. We passed these on to agencies which had the ability to prosecute them.

But, no, you know, I have not frankly gone back and done a retrospective as to what the agency knew and was aware of. A lot of the kinds of

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issues that you've raised here are the things that they know or really things are a little better known in industry -- not to excuse us for now knowing it -- but are better known in the industry circles than they are with us.

What we tend to see on our end is after the problem has hit, the complaints arise at the time that the instruments start to fail. In other words, nobody says they've been defrauded until they -- until the issue actually arises.

CHAIRMAN ANGELIDES: Mr. Ferrer, are you seeing a high correlation between --

I'm going to ask you this also, Mr. Palmer, about both you and your investigations, criminal and civil.

Are you seeing a high correlation between the fraud cases and the, quote/unquote, liar loans, no-doc loans?

MR. PALMER: I'll answer that yes, most definitely. I don't think the --

CHAIRMAN ANGELIDES: Any sense of proportion --

MR. PALMER: No.

CHAIRMAN ANGELIDES: -- of the number of fraud cases that are no-doc loans? Overwhelming?

MR. PALMER: Well, I can tell you this: Every fraud case that we've looked at was linked to no-doc loans.

CHAIRMAN ANGELIDES: All right.

MR. PALMER: Or income-stated loans. Or low-doc I guess is the --

CHAIRMAN ANGELIDES: Low-doc, minimal-doc, no income stated?

MR. PALMER: Yeah.

And when they were low-doc loans and, for example, the bank statements and the employment were often forged and falsified, and when the banks got these, they never looked behind them. They just accepted them as they were.

CHAIRMAN ANGELIDES: All right. Mr. Ferrer?

MR. FERRER: Same here. What we've seen more than anything else is fraud committed in -- when they bring forward the application, their I.D.s. A lot of fraud in the loan origination and the applications in cases that we've seen have been, as Mr. Palmer was stating, simplified mortgage applications, very little verification or documentation to back up the identity or the source of the applicant.

CHAIRMAN ANGELIDES: All right. So I want to press this -- in my remaining time, I want to press this issue again, Mr. Ferrer, with going up the chain. You know, when you describe the chain, you don't -- and if it was ladder, it doesn't seem like you're many steps up it. I mean, there's mortgage brokers. There's realtors, title company folks.

I guess, you know, back to Mr. Black's statement, if you don't look, you will not find, to what extent have you focused -- I mean, given that this was -- there were systemic elements to this, products were put in the marketplace that were easily abused, I know you've identified some bank loan officers, but have you looked at systemic levels of fraud by institutions?

MR. FERRER: We are looking. As I said, we follow the evidence wherever that evidence takes us. Our office does not shy away from prosecuting institutions if the evidence supports that. We did it with Wachovia just this year. We're looking. We are working aggressively.

And, again, this has been a big problem in South Florida. We've prosecuted the most

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defendants in the whole country, our office did, last year. We have AUSAs, Assistant U.S. Attorneys, dedicated exclusively to mortgage fraud and we're working very closely with our state and local partners. If the evidence is there, we will pursue it.

CHAIRMAN ANGELIDES: Mr. Palmer, I know that you pursued Countrywide and other institutions. Give me your perspective on this.

It does seem to me -- I just want to pick up on this. It's just on observation. It does seem to me that the focus of efforts across the country have been highly on the relationship between borrower, originator in whatever form, and very little about the systemic breakdown here that led to such widespread fraud.

MR. PALMER: And that might be the difference between the mortgage fraud, as Mr. Ferrer has been describing, that happens early on, because there's always been people lying to get mortgage loans back probably until Jimmy Stewart and It's a Wonderful Life. But what's happened, the reason it's different now is because of the systemic problem that you're talking about. Because no one is looking at the applications. No one is keeping the loans. So that just provided that opportunity for all this to happen.

CHAIRMAN ANGELIDES: No looking, no keeping. I mean, very fundamental changes.

MR. PALMER: And I will say, if you look at the chart that's in my written testimony, if you look at the lending institutions, by the time you file suit, I don't think any of the lending institutions were there anymore. Because they had -- they were the ones that were issuing the liar loans and just they simply didn't survive. So there wasn't much a point in suing them.

CHAIRMAN ANGELIDES: All right. I yield the balance of my 17 seconds. Thank you very much.

COMMISSIONER GRAHAM: Thank you very much, Mr. Chairman. Thank you to the other Members of the Commission for being here today and to Mr. Thomas.

I also would like to thank all of you who have participated today as parts of our panel or as parts of our audience. The Commission is grateful to each of you. We are especially grateful to the witnesses that have taken the time and effort to

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come and share with us their experience and understanding.

I would like to thank the members of the public and the people of Miami, some of whom have joined us personally and some have joined us electronically by viewing these proceedings on-line. You, the public, can participate in our inquiry by submitting written testimony about how the financial crisis has effected you or your community. If you submit that to the Commission, it will become part of our final report. Please go to fcic.gov, that's fcic.gov, where you will find instructions on how to provide a written submission to this hearings under the "Contact Us" tab.

We'd also like to thank FIU President Rosenberg and Dean Acosta for their generosity in hosting the Commission today. You, Mr. President, Mr. Dean, have an outstanding staff and we have noted their many contributions, including specifically Ms. Nilda Pedrosa, Deborah Sheridan, Frantz Pierre and the IT staff and all of those who have served us through the catering department.

A huge thank you to our staff of the Commission and the ground coordinators for helping

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on the logistics of this field hearing. And I'd specifically like to thank Chip Burpee who keeps me organized and helped keep us organized today. Thank you to each of you.

All right. If there is no further business to come before the Commission, I thank you for coming to our community to give us an opportunity to talk about not a happy subject, but a subject which we will be better for the understanding that this hearing has given us and hopefully the motivation that will come from this to avoid a repetition.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you very much, Senator Graham, and thank you, Commissioners, and thank you, members of the public for being here. Thank you very, very much.

COMMISSIONER GRAHAM: The meeting is adjourned.

(Time noted: 2:19 p.m.)