August 17, 2009

Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, N.W.
Washington, DC 20552
Attention: Comments/RIN 2590-AA11

BY FEDERAL EXPRESS AND E-MAIL: RegComments@FHFA.gov

RE: Reporting of Fraudulent Financial Instruments
RIN 2590-AA11

Dear Mr. Pollard:

The Federal Home Loan Bank of San Francisco ("Bank") appreciates the opportunity to comment on the Federal Housing Finance Agency's ("Finance Agency") proposed rule ("Proposal") implementing Section 1115 of the Housing and Economic Recovery Act of 2008 ("HERA") (12 U.S.C. 4642(a)), published on June 17, 2009, which directs the Finance Agency Director to require the Federal Home Loan Banks ("FHLBanks") and the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (the "Enterprises," together with the FHLBanks ("regulated entities")) to report certain fraudulent transactions to the Director. The Bank generally supports the Proposal and offers the following comments.

Scope and Purpose

The Bank believes the final rule should be revised in Section 1233.3(a) to specify that it requires regulated entities to report to the Director "upon discovery by the regulated entity that it has purchased or sold a fraudulent loan or financial instrument, or suspects a possible fraud relating to [its] purchase or sale of any loan or financial instrument" as stated in HERA § 1115. By paralleling HERA's statutory language more closely, the Finance Agency would help clarify that the rule does not require regulated entities to institute internal controls and procedures to detect fraud and potential fraud in the individual mortgage loans behind a mortgage-backed security ("MBS") purchased by a regulated entity.

The Bank believes that HERA § 1115 was intended to require reporting of fraud or possible fraud directly connected to a loan or other instrument purchased or sold by a regulated entity. The Bank does not believe HERA was intended to require regulated entities to institute internal controls and procedures to detect fraud and potential fraud indirectly connected to instruments the regulated entity purchases or sells. Section 1115 of HERA provides that it requires submission of a report if a regulated entity "has purchased or sold a fraudulent . . . financial instrument." For example, if a regulated entity purchases an MBS from a broker-dealer, the Bank believes the final rule should only require the regulated entity to submit a report if it detects fraud or possible fraud involving the broker-dealer (such as a false statement in the investor documents regarding creditworthiness of the loans held by the trust), but not with respect to potentially fraudulent statements by borrowers on the loans held by the trust (such as a false statement of income in a loan application).

The Bank supports the Finance Agency's proposed definition of "fraud." The Bank believes the definition's requirement that the regulated entity has *relied* on a misstatement, misrepresentation, or omission helps demonstrate that the rule excludes from its scope misstatements, misrepresentations, and omissions by individual borrowers of home mortgage loans underlying MBS purchased by the regulated entity. For the reliance element to be satisfied, we

assume the Bank (or its agent) must actually be aware of the communication containing the falsehood.[1] In an MBS purchase transaction, a regulated entity would not ordinarily have relied directly on communications by individual borrowers. Therefore, in addition to paralleling HERA's statutory language more closely in Section 1233.3(a), the Finance Agency could specify that, for purposes of the rule, a misstatement, misrepresentation, or omission at the individual loan level in an MBS does not trigger a reporting requirement for a regulated entity. To conclude otherwise would imply that the regulated entity relied upon the statements of individual borrowers and would, by implication, nullify the regulated entity's ability to rely on the representations and warranties of the MBS issuer regarding the underlying loans and eliminate a primary benefit of MBS ownership.

The Bank also believes Section 1233.3(a) should be clarified to ensure the final rule complements existing requirements regarding fraud detection and reporting and does not add duplicative reporting and procedural requirements and an additional layer of expense. Pursuant to regulations requiring submission of a suspicious activity report ("SAR") to the Financial Crimes Enforcement Network ("FinCEN"), the obligation to report fraud in an individual loan within an MBS trust already resides with the financial institution originating the mortgage and the broker-dealer selling the MBS. Federal law currently imposes an affirmative obligation to file a SAR on not only broker-dealers, but on insurance companies, mutual funds, commodity brokers, insured depository institutions and their affiliates, and, in essence, all the types of institutions from which the Bank buys securities.[2] The final rule should clarify that the rule does not duplicate these requirements by extending its scope beyond HERA's mandate.

Internal controls, procedures, and training (Proposed § 1233.4)

With respect to a regulated entity's purchases of individual loans, for example through the Mortgage Partnership Finance® ("MPF®") Program, the Bank believes the final rule should specify that a regulated entity may fulfill its obligation to comply with Proposed § 1233.4 with the assistance of a third-party service provider. In the case of MPF, participating FHLBanks engage FHLBank Chicago to perform much of their quality control processes, including mortgage fraud detection. The Bank believes the final rule should specifically acknowledge that adequate and appropriate third-party quality control constitutes fraud detection controls sufficient to satisfy a regulated entity's obligations under Proposed § 1233.4.

Technical Change

The Bank notes the Proposal inadvertently incorporated an overly expansive definition of "Entity-affiliated party" and believes the Finance Agency likely intended to use only subsections (1) and (5) of the definition in the context of the proposed rule so the rule does not protect from liability under § 1233.5 the persons identified in subsections (2) to (4) of the definition of "Entity-affiliated party."

We thank you very much for your consideration of our comments.

Sincerely,

Dean Schultz
President and
Chief Executive Officer

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[1] Common law fraud requires proof of actual reliance. *Good v. Zenith Electronics Corp.*, 751 F. Supp. 1320, 1323 (N.D. Ill. 1990). If, however, the FHFA intends for reliance to be presumed, or to be subject to a rebuttable presumption, it would be important to know the criteria applicable to such a presumption.

[2] *See* 31 C.F.R. §§ 103.15-19; 12 C.F.R. §§ 21.11, 208.62, 211.5(k), 211.24(f), 225.4(f), 353, 563.180, and 748.1.