

## Do You Know Your Customer?

2017 Asset Management & Operations Servicer Workshop



#### **Presenters**





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### **Key Takeaways**



## By the end of today's session we will discuss the following

- Why KYC is a hot industry topic
- Freddie Mac's KYC/AML program
- Suspicious activity and money laundering
- MF fraud schemes/red flags
- Reporting suspicious activity
- Best practices for Know Your Customer



## **Anti-Money Laundering (AML) Overview**



- Know Your Customer (KYC) is a key component of AML programs
- The G-7 Summit in 1989 created the Financial Action Task Force (FATF) to establish an international response to money laundering
- The focus on money laundering increased significantly as a result of the tragic events of September 11, 2001
  - » USA PATRIOT ACT was passed a month later
- The Financial Crimes Enforcement Network (FinCEN) is serious about AML Compliance
  - » Most Financial Institutions are required to have an AML program
  - The United Nations estimates that 5% of global gross domestic product is criminally laundered1

#### Money Laundering is a global problem

<sup>&</sup>lt;sup>1</sup> Money Laundering has Wall Street Freaking Out; New York Post 8/16/2016

#### **AML Program Required**



In 2014, FinCEN (division of Treasury) required Freddie Mac, Fannie Mae and the Federal Home Loan banks to:

1. Establish a written

Anti-Money
Laundering
Program

2. File
Suspicious
Activity Reports
Directly with
FinCEN

Participate in mandatory
 Information
 Sharing
 with FinCEN

- FinCEN has delegated AML program compliance oversight to FHFA
  - » FHFA audits Freddie Mac's AML program

FHFA also mandates anti-fraud policies (Advisory Bulletin 2015-07).

<u>FinCEN</u>, a bureau within the U.S Treasury, has a mission to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis and dissemination of financial intelligence and strategic use of financial authorities.

## **AML Program Required (Cont'd)**

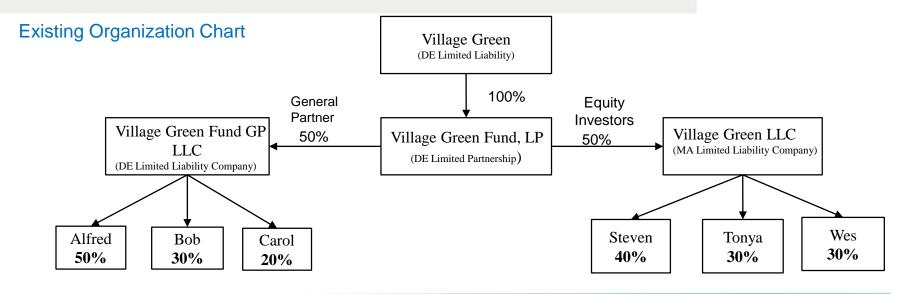


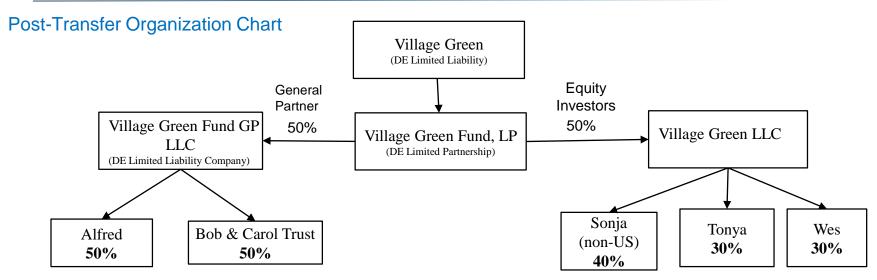
- The AML program has four pillars
  - » AML Compliance Officer
  - » Policies, procedures and internal controls based on a risk assessment
  - » Mandatory ongoing education and AML training
  - » Independent testing of the AML program
- The Beneficial Owner Rule (the "5<sup>th</sup> Pillar") will be effective May 2018;
   it requires identification and verification of beneficial owners
  - » Freddie Mac requires Beneficial Ownership due diligence during the underwriting process and during the life of the loan (assumption, transfer of ownership, note sale, REO sale, etc.)

"Know Your Customer" is a key component of an effective AML program

## Beneficial Owner Example: Who would you conduct watchlist searches on?







#### **Existing KYC Compliance Requirements**



- "It is also important for Seller/Servicers to know the parties with whom they do business"<sup>1</sup>
- "Ensure that information indicating suspected fraud that is received from any source in connections with Servicing functions relating to a mortgage or REO is escalated internally and properly investigated"
- Servicers must provide fraud training (at least annually) to employees and it must include<sup>2</sup>
  - » Common and emerging fraud schemes
  - » Red flags
- Perform watchlist screening (3 Guide mandated lists)

#### All Servicers are required to support fraud prevention and detection

## S/S Guide: Mandatory Watchlist Screening



	OFAC SDN List	FHFA Suspended Counterparty List	Exclusionary List
Owner (Oversight)	U.S. Treasury	FHFA	Freddie Mac
Type of List	Public	Public	Private
Purpose of Screening	Enforcement of economic and trade sanctions against countries & individuals involved in terrorism, narcotics and other disreputable activities	Ensure the regulated entities are not exposed to unnecessary risk from doing business with individuals or businesses subject to a conviction or administrative sanction for certain mortgage related conduct	Protect Freddie Mac from doing business with parties that have shown a lack of integrity or business competency. Indirect and direct transactions are prohibited
Who is Accountable for Screening?	All U.S. individuals & companies whether operating within or outside the U.S.	Freddie Mac, Fannie Mae & Federal Home Loan Banks	Seller/Servicers (Single Family & Multifamily)
List Entries	Individuals & Entities	Individuals & Entities	Individuals & Entities
List Update Frequency	Periodic, no set schedule	Periodic, no set schedule	First business day of each month (or as necessary)

## Suspicious Activity and Mortgage-Related Fraud



Suspicious Activity may involve actual or *possible* money laundering, terrorist activity financing, mortgage-related fraud, or other financial crimes, related to a Freddie Mac mortgage, property, security, or other financial instrument.

Mortgage-Related Fraud is a misstatement, misrepresentation, or omission that cannot be corrected and that was relied upon by Freddie Mac to purchase or sell a loan, other financial instrument or an REO property.

Fraud is *Intentional* 

All fraud is suspicious activity BUT not all suspicious activity is fraud

## **Money Laundering Defined**



Money Laundering refers to the criminal practice of using a financial transaction that aims to conceal the...

- » Identity (the true Beneficial Owner)
- » Source (Higher risk if funds are not from a U.S. financial institution)
- » Destination of illicitly obtained money

#### **Money Laundering** has three stages

- » Placement
- » Layering
- » Integration (Purchase of real estate)

Legitimate Companies can unknowingly be used by Money Launderers

#### Money Laundering – Placement



## Goal: Deposit criminal proceeds into financial system

- Deposit Cash (ATM, teller window)
- Purchase foreign money via currency exchange
- Blending funds
  - » Legitimate company co-mingles illegal funds with actual sales receipts
  - » Cash-intensive businesses are higher risk
- Loan repayment
  - » Illegal funds used to repay loan per amortization schedule
  - » Significant prepayment of principal
  - » Loan payoff soon after origination

## Illegal funds enter the financial system





**Placement** 

Layering

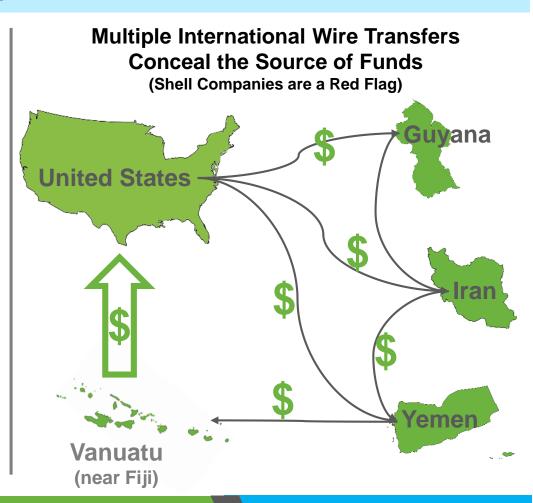
Integration

## Money Laundering – Layering



#### Goal: Separate illicit money from its source

- Usually involves a complex series of transactions to hide the audit trail
- May involve shell companies with no real legitimate purpose
- May involve countries with deficient anti-money laundering programs
- May involve fictitious purchase of goods or services which are paid with illicit money



**Placement** 

Layering

Integration

### Money Laundering – Integration



## **Goal:** Reunite money with the criminal so it appears legitimate and can be used for any purpose without drawing attention

- Integration often involves the purchase of valuable or cash-flow generating assets, including
  - » Residential or commercial property
  - » Cars, artwork, or jewelry
  - » A legitimate business
    - Purchase of a cash-intensive business will enable future money laundering without suspicion
- When the asset is sold, the proceeds appear legitimate
  - » Highest sale price is not a concern













**Placement** 

Layering

Integration

#### **Potential Indicators of MF Fraud Schemes**



- Misrepresentations, false statements, or falsified documentation including
  - » Rent rolls, appraisals, draw requests, lien waivers and financial statements
  - » Misrepresenting the number of rent controlled vs. market rate rents
  - » Forged signatures
- Misappropriation of Funds
  - » Borrower or Borrower Sponsor diverts funds to other projects or for personal use
- Misrepresentation or Transfer of Collateral
  - » Borrower misrepresents the value of the collateral
  - » Borrower sells the collateral without disclosure to lender
  - » Borrower hides conveyance from associates/business partners
  - » Borrower has pledged the same collateral for multiple loans

### MF Red Flags for Fraud



- Documents from a counterparty that appear to be altered (i.e., rent rolls)
- Change of LLC owners shortly after loan is funded
  - Payments received from, or on behalf of, a third party
    - Rush payments, particularly if regular approver is not available
    - Transaction types that are inconsistent with the business source or appear to lack a legitimate purpose
  - Unexpected increases in the frequency or size of typical transactions
    - A counterparty making unexpected payments and then requesting a refund, or requests that funds be sent to a third-party account
  - A security that performs well above or well below expected market levels

#### Red flags require closer review to determine if it's legitimate

### **Potential Fraud in Servicing Processes**



- Rent Roll
  - » Dramatic change in occupancy levels without explanation
  - » Unexplained tenant movement between units / buildings
  - » Change in lease terms
- Property Operating Statement
  - » Unexplained Effective Gross Income (EGI) or Total Operating Expenses (TOE) variances
- Property Site Inspection
  - » Changes in property signage or the unit mix
  - » Units appear to be "staged" with new or minimal furnishings
  - The same furnishings are in multiple units that are not corporate apartments
  - » Minimal personal items or food and the unit is very clean
- Cash Management
  - » Failed ACH drafts, bank account movement, bank account is "frozen"

#### Be mindful of unexplained changes

## **Red Flag Example – Property Inspection**







How would you determine if the unit is occupied or not?

# Red Flag Example – Property Inspection (Cont'd)







### **External Reporting Requirement**



- Freddie Mac reviews all suspicious activity tips and determines if a Suspicious Activity Report (SAR) should be filed with FinCEN
  - » Servicers are not notified if a SAR is filed (Confidential)
- FinCEN receives SARs from
  - » Financial Institutions (including Freddie Mac)
  - » Securities dealers & registered investment advisors
  - » Money service businesses, Casinos



- The SAR database is a powerful tool used by FinCEN, law enforcement and federal regulatory agencies to identify suspects and "follow the money"
- FinCEN partners with and shares information with other countries' financial crime units for global AML compliance

#### SARs are a key to exposing criminal activity patterns

#### **Best Practices**



- What do you consider high risk?
- Audience sharing of KYC best practices
  - » Effective due diligence
  - » Internet searches
    - » Foreign news searches
  - » Effective third-party software tools
  - » Transactions involving international counterparties and the possibility of receiving funds from foreign sources

#### Due Diligence will differ based on the risk factors