



**STATEMENT OF  
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**BEFORE THE  
COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON OVERSIGHT  
AND INVESTIGATIONS  
UNITED STATES HOUSE OF REPRESENTATIVES  
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Chairman Moore, Ranking Member Biggert, and members of the Subcommittee, thank you for inviting me to testify today. I very much appreciate the opportunity to speak on oversight of the Department of Housing and Urban Development. In discussions with your subcommittee staff, it is my understanding that you want me to primarily focus on the important issue of the role of the Federal Housing Administration (FHA) in addressing the housing crisis currently confronting our nation and to touch briefly on a number of other limited topics but leave a more in-depth discussion of other areas of oversight concern for potential later hearings. As the Inspector General of the Department of Housing and Urban Development for the last seven years, as the former Assistant Director of Investigations for the Resolution Trust Corporation during the savings and loans crisis, and before that as a Special Agent in the United States Secret Service investigating financing misdeeds, I have witnessed many decades of financial and economic fluctuations. This is certainly one of the most challenging times.

## **Background**

The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The OIG strives to make a difference in HUD's performance and accountability. The OIG is committed to its statutory mission of detecting and preventing fraud, waste, and abuse, and promoting the effectiveness and efficiency of government operations. While organizationally located within the Department, the OIG operates independently with separate budget authority. This independence allows for clear and objective reporting to the Secretary and to the Congress.

The Department's primary challenge is to find ways to improve housing and to expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs, which include Federal Housing Administration (FHA) mortgage insurance for Single-Family and Multifamily properties, are funded through a \$45+ billion annual budget and, in the case of FHA, through mortgage insurance premiums. Recently, the Department also received over \$13 billion in the American Recovery and Reinvestment Act funding for various programs to stimulate the economy. This is in addition to the almost \$4 billion received for the Neighborhood Stabilization Program in July 2008.

The last two years have seen enormous and damaging developments in the mortgage market: the dissolution of the subprime and Alt-A loan markets; dramatic drops in housing prices in most areas of the country; a concomitant rise in default and foreclosures; financial insecurity in the mortgage-backed securities markets represented by the government takeover of Fannie Mae and Freddie Mac; the collapse of credit markets; and, as a primary vehicle to address these issues, an urgent reliance on the FHA to bolster the mortgage market. As the Mortgage Asset Research Institute has stated, the unprecedented onslaught of financial losses, reputational damages, and rehabilitative public policies will forever reshape the mortgage industry.

While there are other programs at HUD that are being utilized in a significant way to help stimulate the economy (i.e., billions of dollars in new funding to Community Development Block Grants, to increased Public Housing assistance, etc.), which are also vulnerable to fraudulent and abusive activities, the primary focus of this testimony is on the salient issues

facing the FHA program due to the mortgage crisis and to an increased reliance on our Department to potentially resolve matters at this critical juncture. The current degree of FHA predominance in the market is unparalleled.

First off, to put the FHA issues into perspective, we have recently stated in testimony to the Congress that, through the multitude of our work in auditing and investigating many facets of the FHA programs over the course of many years, we have had, and continue to have, concerns regarding FHA's systems and infrastructure to adequately perform its current requirements and services. This was expressed by the OIG to the FHA through audits and reports regarding a wide spectrum of areas prior to the current influx of loans coming into the program and prior to the consideration of the numerous proposals that expanded its reach. We continue to remain concerned regarding FHA's ability and capacity to oversee the newly generated business.

Some of these are long-standing concerns that go back to unresolved issues highlighted in our work products from as far back as the early to mid-1990's. In my discussions with the Secretary, it is clear he is committed to positioning the Department as rapidly as he can to try to deal with the changing dynamics. As the President recently stated, however, the government is an ocean liner, and not a speed boat, when it comes to moving it in a new direction. The same can be said for some of our departmental programs. The Secretary, however, has recently announced a number of new transformation initiatives designed to address some of these concerns and we believe their implementation will be an important step in moving the program into safer territory.

We are also deeply gratified that a number of new legislative initiatives, culminating in recent signing by the President, were based on proposals and recommendations developed by this office (S. 386, the Fraud Enforcement and Recovery Act of 2009 – now P.L. 111-21, and S. 896, the Helping Families Save Their Homes Act of 2009 – now P.L. 111-22). I will elaborate on these developments later in the testimony. It gives our hard-working OIG staff great satisfaction to have been involved in a process that has so quickly resulted in public law.

## **The Evolving Landscape**

The past year and a half have certainly produced a lot of changes and initiatives. In response to increasing delinquencies and foreclosures brought about by the collapsing subprime mortgage market, in September 2007, HUD acted administratively to provide mortgage assistance through the FHA Secure program to refinance existing subprime mortgages. The program was expanded in May 2008 to provide lenders the added flexibility to refinance and insure more mortgages, including those for borrowers who were late on a few payments and/or received a voluntary mortgage principal write-down from their lenders. This program served a fraction of its anticipated scope. The FHA recently issued a formal letter terminating the program stating that "maintaining the program past the original termination date would have a negative financial impact on the MMI Fund."

The Housing and Economic Recovery Act (HERA) passed last summer, created a new Hope for Homeowners program to enable FHA to refinance the mortgages of at-risk borrowers. While activity to date has been very limited, the FHA was authorized to guarantee \$300 billion in new loans to help prevent an estimated 400,000 homeowners from foreclosure. The Congress recently passed and the President signed legislation to revise this program in order to increase participation. The Secretary recently testified, however, that these estimates will not likely be

reached. Nevertheless, these changes, and others, to remedy a dysfunctional mortgage market are likely to increase the challenges to the OIG. While the goal to help homeowners in distress is important, relaxing qualification requirements for borrowers and lenders may create a situation that could be exploited by fraud perpetrators to take advantage of desperate homeowners, at risk-lenders, and the FHA insurance fund. The HERA legislation also authorized changes to the FHA's Home Equity Conversion Mortgage (HECM) program that will enable more seniors to tap into their home's equity and obtain higher payouts which raises new oversight concerns for this agency.

As we turn to today's environment, the volume of Single-Family FHA-insured loans has enlarged in Fiscal Year 2008 by tripling from \$59 billion in Fiscal Year 2007 to over \$180 billion in Fiscal Year 2008. The latest figures from Single-Family market comparisons from the first quarter of Fiscal Year 2009 show that FHA's total endorsements have increased from 24% of the market the year before to 63% of the market which includes both home sales and refinances. FHA's home sales' market share (excluding refinances) has increased from approximately 6% to close to 20% during this time period. Many potential homeowner loans may not have come to the agency yet as some of the new initiatives are still taking hold and the industry is flushing out its options and possibly posturing for more favorable terms.

FHA will be challenged to handle its expanded workload or new programs that require the agency to take on riskier loans than it historically has had in its portfolio. The surge in FHA loans is likely to overtax the oversight resources of the FHA, making careful and comprehensive lender monitoring difficult. In addition, our experience in prior high FHA volume periods (such as from 1997-2001) shows that the program was vulnerable to exploitation by fraud schemes, most notoriously flipping activities, that undercut the integrity of the program. In my conversations with the Secretary, and in initiatives recently announced, I know he is endeavoring to fix some inherent weaknesses. We are pleased that the Congress recently enacted, and the President signed, legislation that strengthens the requirements for lenders to be approved to originate FHA mortgages.

## **Departmental Issues**

Though the recently-passed Omnibus Appropriations bill containing FY 2009 funding will help to alleviate some of its funding constraints, we believe there is a critical need for more resources for FHA: 1) to enhance its IT systems; 2) to increase its personnel to meet the escalation in processing requirements; 3) to increase its training of personnel to maintain a workforce with the necessary skills to deal with the responsibility of this new portfolio; 4) to oversee the numerous contractors it maintains; and 5) to increase its oversight of all critical front-end issues including such important areas as the appraisal, lender approval and underwriting processes. Though the Department will increase its hiring in these areas, it still needs additional resources to adequately deal with new, and ever increasing, program demands.

We are also concerned that increases in demand to the FHA program are having collateral implications for the integrity of the Government National Mortgage Association (Ginnie Mae) mortgage-backed securities (MBS) program including the potential for increases in fraud in that program. HUD too needs to consider the downstream risks to investors and financial institutions of Ginnie Mae's eventual securitization of Home Equity Conversion Mortgage (HECM) Single-

Family loans. Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuer's MBS pools. Like FHA, Ginnie Mae has seen an augmentation in its market share (it has even in some recent months surpassed both Fannie Mae and Freddie Mac) and increased \$150 billion in outstanding mortgage-backed securities and commitments during a one-year period from FY 2007 to FY 2008. It too has stretched and limited resources to adequately address this increase. From a different vantage point, the industry has noted that Ginnie's struggle to keep pace with FHA could also reduce liquidity at a critical moment in the housing market.

The OIG has initiated investigations of Ginnie Mae MBS fraud. In one recent case, the two former corporate officers of a Michigan financial company were convicted of defrauding Ginnie Mae by retaining the funds obtained from terminated and/or paid-off loans. The defendants failed to disclose to Ginnie Mae that the loans were terminated, while one of the defendants utilized the funds from the paid-off loans to invest in the stock market and to make fraudulent monthly payments to Ginnie Mae on the loans that were previously paid-off in order to conceal the fraud. The fraud began during July of 1998 and continued until October of 2007, resulting in a loss of approximately \$20,000,000. Further, a recent audit of the Ginnie Mae program has found that it did not ensure that mortgage-backed securities pools were FHA insured within a reasonable period after pool issuance. Without proper corrective actions, the gap in the MBS program policies and procedures will continue to make Ginnie Mae susceptible to program risks including fraud.

Given all these enumerated issues, we are gratified that a new penalty provision was inserted into the Housing and Economic Recovery Act last summer (now 18 U.S.C. Section 1014). When we corresponded during consideration of that legislation, we stated our belief that a new penalty enunciated specifically for the FHA program would be beneficial from an oversight and enforcement perspective. We assisted in its development and were very pleased that it was included in the final passage. The statute now creates a penalty of up to \$1 million and 30 years in prison for committing fraud against FHA programs, similar to the predicates established in the Financial Institutions Reform, Recovery and Enforcement Act, and will be a useful tool for prosecutors and the law enforcement community to employ in order to address those who would seek to defraud the program.

### **OIG Observations**

The results of the latest actuarial study, though now somewhat dated, show that HUD has sustained significant losses in its Single-Family program making a once fairly robust program's reserves smaller. The study shows that FHA's fund to cover losses on the mortgages it insures are contracting. As of September 30, 2008 the fund's economic value was an estimated \$12.9 billion, an almost 40 percent drop from over \$21 billion a year ago. The \$12.9 billion economic value represents 3 percent of the mortgages insured by the FHA. Although above the 2 percent ratio required by law, it is well below the 6.4 percent ratio from September 30, 2007. Moreover, these latest projections used macroeconomic forecast data as of June 2008 and are profoundly sensitive to the accuracy of those forecasts. If more pessimistic assumptions are factored in, the

ratio could dip below 2 percent in succeeding years requiring an increase in premiums or Congressional appropriation intervention to make up the shortfall.

Since its inception in 1934, FHA has been self-sustaining and premiums paid to the fund have covered the losses due to fluctuating defaults and foreclosures. The Secretary testified last week that there should be a surplus but re-estimations will be done over the summer. The Department has begun the process of performing its annual actuarial review of the FHA fund. Through our oversight responsibility, our auditors are also performing an independent review of the Department calculation and economic assumptions. Given the current economic conditions, it is critical that the assumptions used to derive the current estimate of the health of the fund be supportable and not overly optimistic.

As we have stated before, we think it might be useful for the Department to conduct interim assessments of the viability of the fund and we are aware that Rep. Lynch recently introduced legislation that would require a more frequent semiannual actuarial study. Resources will need to be given to the Department to take on this new requirement if it should become law but a more frequent study would give lawmakers the ability to determine the health of the fund in a more timely way.

A significant problem facing FHA, and the lenders it works with, is the fallout from decreasing home values. This increases the risk of default, abandonment and foreclosure, and makes it correspondingly difficult for FHA to resell the properties. About 7 percent of FHA loans are currently in default (i.e., more than 90 days non-payment status, foreclosure or bankruptcy). The Mortgage Bankers Association reports a 30-day + delinquency rate for FHA loans of over 13 percent. A major concern is that even as FHA endorsement levels meet or exceed previous peaks in its program history, FHA defaults have already exceeded previous years. The Secretary recently testified that he is sending SWAT teams in to try to head off the ramifications from early defaults on the FHA fund.

This, however, reinforces the importance for FHA approved lenders to maintain solid underwriting standards and quality control processes in order to withstand severe adverse economic conditions. Another extensive problem confronting FHA has been its inability to upgrade and replace legacy (developed in the 1970s and 1980s) application systems that had been previously scheduled to be integrated. The FHA systems environment remains at risk and must evolve to keep up with its new demands. Add to that an escalation in the properties owned and managed by FHA and the overall picture becomes more complicated.

### **Increased Risks to FHA:**

Until recently, FHA's market share remained quite low as conventional subprime loans were heavily marketed by lenders. The tightening credit market has increased FHA's position as a loan insurer and, with that, is coming an increase in lender/brokers seeking to do business with the federal program and an overall concern regarding some of these loan originators. For example, we currently have under investigation, for alleged inappropriate activities, several FHA lenders who were also lenders in the subprime market. The movement towards HUD is already underway as reflected in recent statistics. FHA approval of new lenders increased 525% in a two-year period. For example, as of the end of Fiscal Year 2008, FHA had over 3300 approved lenders as compared to 997 at the end of Fiscal Year 2007 for an increase of 330%. If you

compare the FY 2008 totals (over 3300) to the FY 2006 totals (692) it is a 525% increase. Lender approvals for the first half of FY 2009 currently total about 1600.

The integrity and reliability of this crop of program loan originators is, in our view, unproven and, in light of the aggressive recent history of this industry, may pose a risk to the program. The Mortgage Bankers Association (MBA) in recent testimony stated the "MBA is concerned that since the once lucrative subprime market has evaporated, some of the less scrupulous lenders who specialized in that business are now turning their attention to FHA lending."

In addition, we have seen lenders reacquiring FHA approval despite past abuses. A previous investigation on an FHA lender in New York led to the debarment of its owner for a period of five years from originating FHA insured loans. After the debarment was served, the lender, under the same owner, resumed operations using the same fraudulent practices. We again reviewed some of the loans and determined that the originations were fraudulent similar to the loans investigated in the first case. The OIG, in conjunction with the U.S. Attorney's Office and departmental officials, sought and received an injunction against them in order to stop the business from operating. At the same time as the injunction, FHA withdrew their lender approval.

Our audit work also highlights how problem lenders may regain admission into the FHA program even when previous transgressions were apparent. For example, we reviewed an Arizona corporation that was approved as an FHA mortgage lender by HUD in 1996. This particular lender had 13 active branch offices and sponsored close to 2,000 FHA-approved loan correspondents nationwide. As highlighted in our audit, this lender had a number of serious issues related to Real Estate Settlement Procedure Act (RESPA) violations such as paying marketing fees, non-competition fees and quality incentives to real estate companies in exchange for more than \$57 million in FHA mortgage business. The corporation's license was suspended by the State and it filed for bankruptcy. One of the principal owners and principal managers reconstituted under a different name but operates from the same location. In 2008, HUD approved the new entity to originate and process FHA loans despite its principals' prior citations for RESPA violations.

In our previous testimony and in our discussions with staff of Senate Committee on Banking we spoke to this dilemma regarding an FHA focus on entities rather than individuals. We are extremely gratified that S. 896 contains numerous provisions directed at this problem by, for example, extending civil monetary penalties to owners, officers, or directors and not just the "mortgagee or lender," and by denying eligibility for approval to officers, partners, directors, principals, managers, supervisors, loan processors, loan underwriters, or loan originators who may have been, among other things, suspended, indicted, convicted or had unresolved findings contained in an OIG audit or an investigation. We are also pleased that the Senate Committee on Judiciary included provisions in S. 386 to amend the definition of financial institution to include mortgage brokers. Our testimony on former subprime players entering into the FHA arena was of concern to the Committee during drafting of this important legislation.

Adding to the risk, FHA is now, due to loan limit increases, serving new metropolitan areas with which it previously has had little interaction. Recent legislation increased maximum FHA loan limits to \$729,750. With such entry, into these new markets, come new players and unknown hazards. The effects of this significantly increased loan limit are potentially much greater losses

sustained by FHA on defaulted loans and that the loans may be much more attractive to perpetrators of fraud who will be able to extract greater payouts in fraudulent loans schemes.

Simultaneous to this confluence of events, is an increase in the reported incidents of mortgage fraud. As the Federal Bureau of Investigation (FBI) points out, a significant portion of the mortgage industry is void of any mandatory fraud reporting and presently there is no central repository to collect all mortgage fraud complaints. Mortgage fraud incidents reports, as compiled, however, by the Mortgage Asset Research Institute in the overall marketplace, have increased by 45 percent in the second quarter compared to a year-ago period. Its most recent third quarter assessment states that fraud incidence is at an “all-time high” and that “reported mortgage fraud is more prevalent now than in the heyday of the origination boom.”

Our long-term investigative exposure in the area of mortgage fraud schemes impacting both FHA and conventional loans (since most fraud schemes cross loan programs) has given us vast experience and extensive knowledge. Many “**traditional**” fraud schemes continue to affect FHA and are described below:

- **Appraisal Fraud** – typically central to every loan origination fraud and includes deliberately fraudulent appraisals (substantially misrepresented properties, fictitious properties, bogus comparables) and/or inflated appraisals (designed to “hit the numbers”); appraiser kickbacks; and appraiser coercion.
- **Identity Theft** – often includes use of bogus, invalid or misused Social Security numbers and may include involvement of illegal aliens, false ownership documents or certifications.
- **Loan Origination Fraud** - including false, fraudulent and substantially inaccurate income, assets and employment information; false loan applications, false credit letters and reports; false gift letters; seller-funded down payments; concealed cash transactions; straw buyers; flipping; kickbacks; cash-out schemes; fraud rings; and inadequate or fraudulent underwriting activities.

While these types of mortgage fraud schemes continue to operate, changing market conditions have generated **new, or variant**, schemes:

- **Rescue or Foreclosure Fraud** - recent trends show that certain individuals in the industry are preying on desperate and vulnerable homeowners who are facing foreclosure. Some improper activities include **equity skimming** [whereby the homeowner is approached and offered an opportunity to get out of financial trouble by the promise to pay off the mortgage or to receive a sum of money when the property is sold -- the property is then deeded to the unscrupulous individual who may charge the homeowner rent and then fails to make the mortgage payment thereby causing the property to go into foreclosure] and **lease/buy-back plans** [wherein the homeowner is deceived into signing over title with the belief that they can remain in the house as a renter and eventually buy back -- the terms are so unrealistic that buy-back is impossible and the homeowner loses possession with the new title holder walking away with most or all of the equity].
- **Bankruptcy Fraud** – typically Chapter 7 bankruptcy petitions are filed in lieu of Chapter 13 petitions on behalf of debtors; however, property sales information is fraudulently withheld

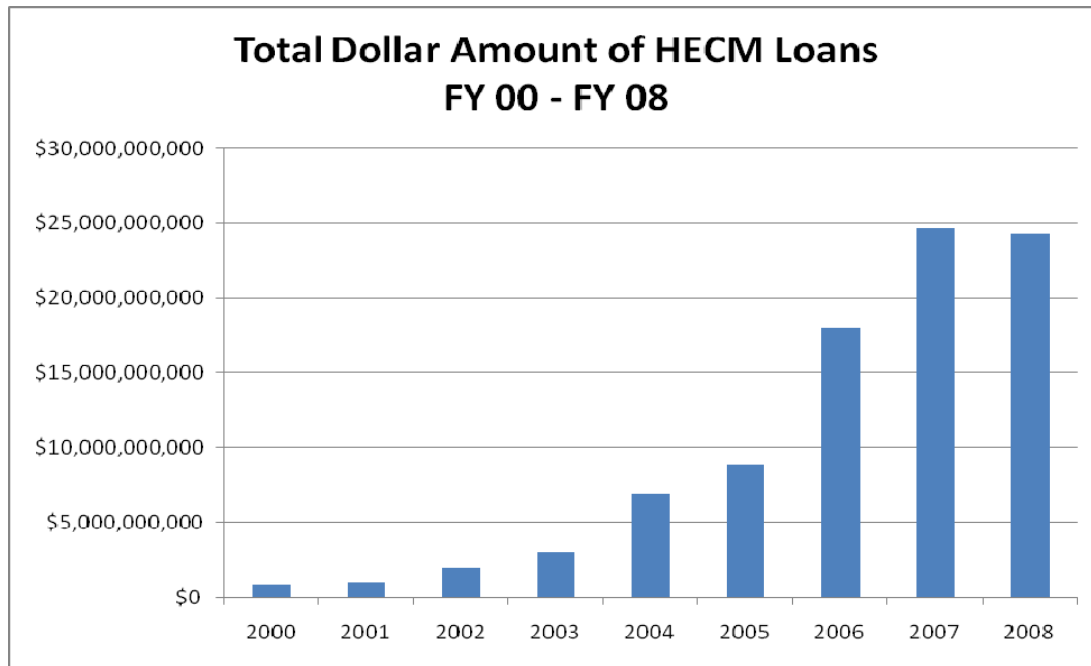


from the bankruptcy court and the properties are leased back to the debtors at inflated rents. The debtors' property ownership and equity are stripped from them.

- **Home Equity Conversion Mortgage (reverse mortgage) Fraud** – FHA reverse mortgages are a new and potentially vulnerable area for fraud perpetrators. We are aware that the larger loan limits can be attractive to exploiters of the elderly, whether it is by third parties or by family members, who seek to strip equity from senior homeowners. Due to the vulnerability of the population this program serves, we are also concerned about evasions of statutory counseling requirements, fraud by counseling entities, misleading sales claims, or incomplete compliance with the dispensing of required counseling information. We are working with the Chairman and members (Senator McCaskill, in particular) of the Senate Committee on Aging and the Chairman of the House Committee on Financial Services to address some of their concerns regarding these issues. We have also been partnering with the AARP and other groups to foster consumer protection education awareness. The following represent some of the types of schemes that we are encountering:
  - **Flipping** - the perpetrator creates a fake mortgage company and 'lends' funds to the borrower (no money changes hands, no loan is given, but a mortgage is filed). The subject refinances the borrower into a HECM. At closing the title company pays all outstanding debt including the fraud perpetrators' fake mortgage and the perpetrator walks away with the payoff.
  - **Recruitment** - Some HECM-related fraud activities involve an investor who sells the property to an elderly straw buyer and enters into a quit claim deed with the straw buyer. The buyer applies for the HECM loan within a short time frame and the appraisal used to originate the HECM loan is then fraudulently inflated. This allows the investor to illegally divert the proceeds of the loan. Straw buyers are "recruited" in residential areas with a high rate of renters. The buyers are often unaware that they must pay property taxes and some are unaware that the cash due to them at closing has been diverted. A current investigation involves recruiting elderly homeless to live in properties victimizing these seniors who often have desperate needs.
  - **Annuity** - Another activity that we currently have under investigation involves financial professionals fraudulently convincing HECM borrowers to invest HECM proceeds in a financial product, such as an annuity, in an improper way. The financial professionals receive increased fees and, in the case of annuities, the victims are unable to get access to their savings for many years or even past their projected life expectancy.
  - **Unauthorized Recipient** – Individuals, often family members, may keep HECM payments after the authorized recipient dies or permanently leaves the residence.
  - **Onerous Fee Payments/Consumer Fraud** – Just this last week, an OIG investigation led to an indictment in Maryland as a result of our participation in a local Elders Task Force. An elderly woman complained that her former health insurance representative stole approximately \$200,000 from her HECM by convincing her she needed to pay him a fee to process her loan application and to repay him the reverse mortgage loan amount. He told the victim she had to repay the

loan by writing personal checks to him and she paid from funds received as well as from her retirement annuity and from cash advances on her credit card. We are currently in the process of identifying more reverse mortgage victims.

HECM loans represent a significant investment by FHA, with considerable recent increases. The chart below shows a 253% increase in the dollar amount of HECM loans from 2004 through 2008:



The OIG plans to work with the Office of the Comptroller of the Currency who is also concerned about this growing area and who believes particular attention needs to be paid to whether to impose additional requirements with respect to escrows of taxes and insurance. Nonpayment of taxes or insurance can trigger foreclosure. However, the new Federal Reserve Board escrow requirements for 'higher-priced' mortgages do not apply to reverse mortgages, and HUD does not require escrows to be established in connection with HECMs. The Comptroller thinks it would be a major step for HUD to issue guidelines addressing the escrow issue. We too are concerned about HUD's exposure on taxes and insurance on HECMs and that escrow may not be sufficient to support these fees. It is our belief that this may be caused by the misleading advertisement by lenders. Also, we note that the Department has recently requested close to \$800 million for the HECM program. In its budget, it states that "the need for appropriated funding for this program reflects the sensitivity of reverse mortgages to changes in home price assumptions. An indefinite appropriation will support the program should actual demand exceed the Budget's projection."

In addition to the schemes described previously, the following case histories also illustrate some of the other types of prevalent mortgage fraud that the OIG typically encounters:

- In February, 2009, a former mortgage broker from Leawood, Kansas was sentenced to 154 months in prison and 60 months probation, and the former owner of a mortgage company from Olathe, Kansas was sentenced to 4 months in prison and 4

- months house arrest and 36 months of probation for obtaining over \$12 million in mortgage loans by submitting fraudulent information to lenders, including false representations on borrower income and employment, false lien information, false sales contracts and by laundering over \$2 million in proceeds through straw business entities. Awaiting sentencing is a previously convicted felon (and former apprentice real estate appraiser) who pleaded guilty to stealing the identities of licensed appraisers approved by the FHA in order to create fraudulently inflated appraisals which then resulted in excess of \$20 million in fraudulent loans. He obtained license numbers from the internet.
- In January, 2009, in Philadelphia, Pennsylvania, an appraiser and two settlement agents, were collectively sentenced to 45 months incarceration and 9 years probation and ordered to pay HUD \$235,802 in restitution for their earlier guilty pleas to making false statements to HUD and committing a conspiracy and wire and identity fraud. The defendants and others provided fraudulent appraisals and other documents used by unqualified borrowers to obtain FHA-insured mortgages. HUD realized losses of \$4,460,588 after 183 mortgages defaulted.
  - In September, 2008, two defendants in South Florida were charged in a 21-count indictment for their participation in a mortgage fraud scheme that resulted in the approval and disbursement of six mortgage loans totaling \$980,000. According to the indictment, one of the defendants, through his company, sold six properties in Miami-Dade County to unqualified buyers using FHA loans. In all six sales, the same defendant, through straw donors, fraudulently financed the down payments and closing costs of the buyers. The second defendant, one of the false donors, was also a silent investor in the scheme. Both defendants allegedly received sizable payments once the properties were sold. When the loans were closed, four of the six properties went into foreclosure.
  - A sampling of FHA loans from a mortgage company in Olathe, Kansas indicated that the loans were issued to Social Security Numbers belonging to deceased individuals. An investigation revealed that this company originated 78 FHA insured loans totaling over \$5 million and 31 conventional loans totaling close to \$2.8 million to illegal aliens using stolen Social Security Numbers. The owners of the company were sentenced to 8 months in jail and 18 months probation and were ordered to repay \$1.8 million in FHA insured loans.
  - In Rockford, Illinois, a loan officer, realtor, loan processor, and company employers were charged with conspiracy, making false statements to HUD, and mail fraud, in a 35-count indictment. Specifically, the defendants were alleged to have engaged in a complex scheme to defraud HUD through a litany of false and fraudulent statements on FHA loan applications. These included, but were not limited to, the following: verifications of employment, pay stubs, W-2's, credit letters, cashier's checks, Social Security Numbers, Social Security cards, and letters containing Social Security Administration letterhead. Overall, 50 FHA loans were in question, with losses totaling in excess of \$2 million.

- **Nursing Homes/Section 232** - The FHA insures mortgage loans (Section 232) to facilitate the construction and rehabilitation of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities. It also allows for the purchase or refinancing of existing projects not requiring substantial rehabilitation. It insures lenders against the loss on mortgage defaults. The current Section 232 regulatory agreement does not prevent transfer of the Transfer of Need associated with the property; does not include receivables in any security documents (which is a significant asset to the properties and can limit HUD's loss when retained); and does not require a lessee operating the project to abide by the same requirements as the owner. This allows lessees to use project funds for non-project expenses to the point of default with no recourse. With such a vulnerable population, the OIG has been recommending for years in numerous audits and investigations that the regulatory agreement needs to be changed.

Currently, the Department has developed a new regulatory agreement for the owner and the lessee that will incorporate the above changes. However, this will only affect new owners and lessees in the program. The new agreement still requires OMB approval prior to being issued in the Federal Register for public comment again. This status has not changed since approximately the fall of 2006.

### **OIG Concerns Regarding Critical Front-End and Back-End Processes** **(improving the quality of FHA originations and the enforcement of bad actors):**

To some extent, the FHA has had to work with the hand it was dealt in terms of funding and of industry-led initiatives to diminish its authority. As others have noted, the FHA cannot keep pace with an industry that is increasingly technology driven, and it cannot use its revenues to invest in any new technology. Many of its deficiencies could be mitigated with additional resources dedicated to systems and staffing enhancement. Our audit and investigative work point to critical front-end and back-end process issues that, if strengthened, could enable the FHA to overcome some of its present vulnerabilities. Some of these areas, that we have previously testified to, were partially addressed in recently signed legislation and in newly-announced departmental initiatives.

**Appraiser Oversight:** Our work of the FHA appraiser roster identified more critical front-end weaknesses as evidenced in the quality control review and monitoring of the roster. The roster contained unreliable data including the listing of 3,480 appraisers with expired licenses and 199 appraisers that had been state sanctioned. In a further review, we found that HUD's appraiser review process was not adequate to reliably and consistently identify and remedy deficiencies associated with appraisers.

The FHA's current Single-Family insured exposure totals over \$560 billion representing 4.8 million FHA-insured mortgages. Inflated appraisals cause higher loan amounts. If the properties foreclose, the loss to the insurance fund is greater. With significant increases in volume and new responsibilities in the mortgage marketplace, we do believe it may be time for the Department to return to an FHA Appraiser Fee Panel similar to the one dismantled by statute in 1994. It is essential if the mortgage industry wants to overcome perceptions regarding its integrity and its role in the current economic crisis that it ensures true market values are correctly estimated.

Such a move would relieve pressures on appraisers to return predetermined values and would change a system based on misplaced incentives. A recent study indicated that 90% of appraisers had felt pressure “to hit the number” provided (i.e., on the sales contract). The old FHA fee panel was rotational and guaranteed work as long as the appraiser met certain HUD requirements.

Our concern that appraisers tied to lenders may impact the quality of the FHA appraisal was also a matter of interest elsewhere as evidenced in last year’s settlement involving Fannie Mae and Freddie Mac and the New York Attorney General whereby lenders selling loans to those entities were required to follow stricter guidelines to ensure that people involved in the processing of loans did not also choose the appraiser. The new Home Valuation Code of Conduct, while an improvement, contains vulnerabilities whereby the lending community still may have the potential to manipulate appraisal management companies who do not necessarily appraise in a way that some unscrupulous lenders may desire. Although still early in the new process, we are not sure that if such paid appraisers are not “hitting the mark,” what is to stop those lenders from threatening to go elsewhere to do business? While the FHA fee panel was disbanded a number of years ago, the Department of Veterans Affairs has not abandoned this concept and we believe that this Department might want to follow suit thus eliminating the relationship between the loan officers, real estate agents and appraisers. We should remain cognizant that the downstream negative effect of overinflated appraisals is long-term and can be fundamentally corrosive to the housing market and to even, as we know today, the world economy.

**Late Payment Endorsement Requirements Changed:** Results from a number of other key audits have noted significant lender underwriting deficiencies, inadequate quality controls, and other operational irregularities. In another important front-end audit, we analyzed the impact of FHA late endorsement policy changes affecting FHA insured loans. On May 17, 2005, the Federal Housing Commissioner issued Mortgagee Letter 2005-23, which significantly changed the requirements for late endorsements for Single-Family insurance. A request for endorsement is considered late whenever the loan binder is received by the FHA more than 60 days after mortgage loan settlement or funds disbursement, whichever is later. The Mortgagee Letter removed the prior six-month good payment history requirement for these loans and provided an additional 15 days grace period before the current month’s payment was considered late.

We conducted a review of this rule change and found that, although FHA asserted the change did not materially increase the insurance risk, FHA did not perform a risk analysis to support this determination. Our review of the performance of loans from seven prior OIG late endorsement audits (i.e., Wells Fargo, National City Mortgage, Cendant, etc.) found a three and one-half times higher risk of claims when loans had unacceptable payment histories within the prior six months. Since the issuance of the Mortgagee Letter, the default rate for loans submitted late has increased and is significantly higher than the default rate for loans submitted in a timely manner. The HUD Handbook itself acknowledged the risk of unacceptable payment histories by stating that “Past credit performance serves as the most useful guide in determining a borrower’s attitude toward credit obligations and predicting a borrower’s future actions.”

We issued an audit report in 2006 and recommended that HUD rescind the Mortgagee Letter until appropriate rule changes could be designed that were supported by an adequate risk

assessment. The FHA disagreed with our audit report and declined to implement the audit recommendations. We referred this matter to HUD's Deputy Secretary who concurred with our recommendations on February 27, 2007 and ordered the FHA to immediately rescind the Mortgagee Letter.

Initially, the FHA agreed to implement the Deputy Secretary's directive but failed to take action, instead taking efforts to again dispute our audit results. This continued until April 2008, when the Deputy Secretary's office again intervened, at our request, and instructed the FHA to publish the proposed rule change in the Federal Register reinstating the six month payment history requirement for late endorsements. In June 2008, the proposed rule change was published in the Federal Register for comment.

Although the final rule rescinding the Mortgagee Letter was never published, FHA nevertheless closed the audit recommendation. Indeed it was not implemented, therefore, in a memorandum dated March 18, 2009, we informed the FHA that, given the amount of time that had lapsed and the absence of a corrective action, the OIG would report this in our next Semi-Annual Report to Congress. Given the current mortgage crisis, concerns over losses to the insurance fund, and requirements for transparency, we believe that this is an important recommendation that should not be dismissed.

The Department attempted to issue new rules for Good Faith Estimates under the Real Estate Settlement Procedures Act in 2002. The rule would have provided additional information to provide borrowers a better understanding of the condition and terms of their proposed mortgages. The Department was unable to finalize the rules. In 2008, due to the mortgage crisis the Department again published proposed rules. The Department issued the final rules in November 2008. The new rules would have provided borrowers with additional information in the Good Faith Estimates. However, the implementation of the rules has been delayed due to procedural issues. The Department is currently working to resolve those issues.

**Capturing Key Information in, and Upgrading, Data Systems:** Another major concern, touched on earlier in the testimony, is the integration and upgrading of FHA legacy systems. While there has been much discussion on an overall plan, and what particular types of systems are needed to go forward, we think it would be useful at this juncture to reposition the discussion to ascertain which data should actually be collected, and maintained, in the system in order to control the new demands placed on the program. Our audit work and our investigative "Systemic Implication Reports" transmitted to the Department over the years, makes it clear that, at a minimum, we need the system to track identifying information on key individuals involved in the transaction such as the originating loan officer.

This person, for example, is central to the initiation part of the loan process where due diligence should hypothetically be done on the application material (i.e., credit scores, appraisal information, etc.). We would like to see that that person's name and corresponding identifying information (i.e., license, etc.) are put in FHA's data fields. This will allow the FHA and OIG to key in on a vital part of the loan process in which fraud typically can occur. If the system could also capture information on other key players such as the real estate agent for the seller and

buyer, and other parties to the transaction, that too would be helpful for purposes of increasing integrity in the processes in our investigative and audit functions.

Further, we think it could be beneficial for the FHA to come together more significantly in a unified lender oversight consortium with Fannie Mae, Freddie Mac, the Federal Deposit Insurance Corporation, and Ginnie Mae in order to, among other things, create standardized forms that could produce common machine readable data fields with consistent information as well as to leverage existing data systems.

Additionally, FHA will be challenged within current resource constraints to keep up with the increasing volume of entities doing business. FHA controls currently rely upon random, manual processes by contractors to select for review approximately 2 percent of lender endorsements, a decrease from 5 percent due, in part, to an increase in volume and to funding limitations.

FHA then relies upon post-endorsement automated lender or service performance information, such as high delinquency or early default rates, to target these entities for examining a limited number of loans for quality assurance reviews. We believe FHA needs the resources to take advantage of commercial off-the-shelf pre-screening loan software, or to require at least the larger lenders use such tools as part of their underwriting process, and the Secretary has touched on software needs in recent testimony as well.

**Lender Approval Process:** Earlier in this testimony we discussed the increasing number of applicants coming into FHA for lender approval and the abuses that could result. It should be noted that FHA's lender approval process, like the review of loan processes described in the preceding paragraph, is largely manual. The FHA lender approval procedure has different requirements dependent on the type of lender making the application. The general process appears to try to strike a balance between not overburdening the applicant with extraneous requirements with a need for important oversight information. In light of the recent aggressive history of the industry that is now seeking to do business with this Department, we thought it prudent to enhance the standards and qualifications for participation. While we are currently auditing this process and will make recommendations when the work is completed, due to the urgent nature of the current circumstances confronting the nation and this Department from the fallout of the mortgage crisis, we recommended to Congress and the Department that some interim steps were needed.

S. 896, now public law, contains a new provision requiring the Department to expand the existing process for new applicants for approval to identify those who represent a high risk to the FHA fund and to implement procedures for those mortgagees approved during the 12-month period preceding to expand the number of mortgages originated by these mortgagees for review for compliance and to include a process for random reviews. In addition, we also spoke to the Senate Committee on Banking during the drafting of this legislation regarding the eligibility process for approval to the FHA program and are again gratified to see that sections were included to deny eligibility to those: suspended, debarred or under limited denial of participation; under indictment; subject to unresolved findings in an OIG investigation, audit or review; engaged in business practices that demonstrate irresponsibility; or are convicted of a felony related to participation in the real estate or mortgage loan industry. These are all

provisions we had advocated and we look forward to these being implemented and believe they will go a long way to address some of the problems we have set forth.

**Mortgagee Review Board:** As we move to a discussion of essential back-end processes, we note that we have recently completed a review, at the request of Senator Grassley, of the Mortgagee Review Board (MRB) enforcement actions and its efficiency, effectiveness and impact in resolving cases of serious non-compliance with FHA regulations particularly during this period of significant changes in the housing market. FHA Single-Family endorsements total \$71.7 billion in the first quarter of 2009, up 245% from the same period a year earlier, emphasizing the need for a strong deterrence to irregular mortgage lending practices. The MRB is a statutorily created board within the Department that has responsibility to sanction FHA-approved lending institutions that violate applicable housing laws and HUD regulations and policies. Established in 1989, it is the sole authorized enforcement body at HUD to remove noncompliant FHA lenders.

Specifically, our review found that the MRB's sanctions directly affected only a small number of lenders. The violations for which the MRB cited lenders rarely warranted withdrawal of FHA lending authority. The sanctions and fines obtained against lenders were frequently mitigated. Elapsed time to complete Board action was slow. The MRB's public visibility was also greatly reduced because the results of its rulings were not published in the Federal Register in FY 2008 as required or otherwise disseminated on HUD's Web site.

Since FHA lending authority is held by more than 12,000 mortgagees and loan correspondents, FHA relies on risk management tools other than the MRB to protect its portfolio and the insurance fund including computerized monitoring of loan default and claim rates, post-endorsement underwriting and appraisal reviews, and on-site lender monitoring. Nevertheless, we believe that a strong deterrence to abusive practices is an effective Board that reaches in a significant way to problematic lenders by, for example, imposing penalties viewed as of real financial consequence to the violating lender, by hearing cases against larger numbers of violators, and by better exposing decisions, in an effort to increase transparency, on more publicly visible sites such as the Department's website. Similarly, the Mortgage Bankers Association, in recent testimony, stated that the "FHA should have more aggressive, streamlined and timely processes to expel 'bad actors'." S. 896 contain a number of new provisions to address our concerns regarding the weaknesses in this area including a prohibition on certain limitations on the Board's power to take action against mortgagees.

This past week, the MRB suspended three lenders while an investigation into business practices was completed. Each had specific issues involving certain business activities and we note that the Department has enhanced its efforts in this regard. Our future inspections work relating to the MRB will focus on the collection of penalties and indemnifications and the referral process from internal HUD centers to the Board.



## **Other Concerns**

In conversing with Subcommittee staff prior to the hearing, there were a few areas that were requested that this testimony touch on that were not related to the FHA or the Ginnie Mae programs.

**Public Official/Management Corruption:** The HUD OIG remains committed to vigorously investigating instances of malfeasance by those entrusted to run or to manage programs receiving federal funds. Last month, the HUD Multifamily Hub Director from Kansas City was indicted on 10 counts of theft of public funds and 10 counts of wire fraud. The Director supervised close to 90 employees and had responsibility for overseeing multifamily offices in Kansas, Missouri, Iowa, Nebraska and Oklahoma. He is alleged to have claimed to have worked when he was gambling at a casino or was playing tennis.

In another area, recent press reports highlighted that allegedly three employees affiliated with the Housing Authority of New Orleans (HANO) fabricated purchase orders and pocketed monies allocated for public housing. The three were placed on administrative leave. The HUD OIG recently released three audits at the request of Senator Landrieu related to the receivership of HANO including a report on the Authority's performance of its contracting activities and financial functions. In that report, we concluded that the Receiver did not ensure that the Authority correctly supported its expensed funds, monitored or correctly paid its contractor, or supported its disbursements.

In a New York case, a non-profit organization serving low-income tenants was charged with embezzling funds. This organization provided management services to two Section 8 properties. Between 2002 and 2008, representatives of the organization charged approximately \$180,000 to its federally funded account purchasing personal items such as clothing, shoes, meals at restaurants, florists, groceries, and furniture. In addition, they paid for new flooring to an Assembly Member.

## **OIG Challenges**

The task before the HUD OIG is a daunting one - addressing the elements of fraud that were involved in the collapse of the mortgage market; monitoring the roll-out of new FHA loan products in order to reduce exploitation of program vulnerabilities; and, combating perpetrators of fraud, including those who have migrated from the subprime markets, who would exploit FHA loan programs. The consequences of the current mortgage crisis, its worldwide economic implications, and the subsequent pressures placed on the Department and OIG could not have come at a more inopportune time. The Department, as a whole, has had significant new leadership responsibilities over the last seven years in rebuilding communities devastated by disasters (i.e., lower Manhattan post-September 11<sup>th</sup>; the Gulf Coast region after hurricanes Katrina, Rita and Wilma; the Galveston area after recent hurricanes; California fires; and Midwest flooding) that have added tens of billions of dollars in new program funds that require quick distribution and keen oversight. In addition, HUD received close to \$4 billion in the Neighborhood Stabilization Program and over \$13 billion in the American Recovery and Reinvestment Act that again requires rapid dissemination to an even more widespread area.

While there have been some monies appropriated for salaries and expenses needed for administering all these new programs and the recent passage of the Fiscal Year 2009 Omnibus Appropriation bill will help, the Department has historically not received analogous increases needed to deal with this new influx of requirements. They, and we, are quite stretched in our combined ability to keep up with the pace of new, critical needs and the changing dynamics of fundamental demands placed on the Department. The Subcommittee asked us to describe our personnel and resources.

The HUD OIG is organized into four offices: Audit, Investigation, Counsel, and Management and Policy. The Office of Investigation also contains Inspection and Evaluations, a rapid deployment group. The Offices of Audit and Investigation have offices in all 10 HUD federal regions as well as 48 duty stations throughout the nation. We currently have 650 full time staff members including 222 criminal investigators, 215 auditors, and 213 employees in other staff series such as attorneys, computer specialists, management analysts and administrative staff. In 2001, HUD OIG held a level of 705 FTEs.

While at one time, for example, we were able to operate mortgage fraud task forces on an exclusive basis, today's OIG agent is also tasked with conducting investigations related to HUD's designated management challenges, which include corruption in the administration of Community Planning Development grant programs; corruption in the administration of public housing authorities; multifamily projects; rental fraud by landlords and tenants; and disaster fraud, to name a few. These multiple challenges are supported by less investigative staff than were available in 1999. These staff members are the oversight for a Department that currently contains more than \$62 billion in appropriated funds and has loan guarantee levels of hundreds of billions of dollars each for the FHA and Ginnie Mae programs. We are working diligently to address the range of audits and investigations needed to oversee all of the HUD's current operations. We recognize that our ability to keep pace is one component to the overall health of our national programs.

Subcommittee staff prior to this hearing asked if there were any legislative remedies that might alleviate some of our funding issues. The OIG is often confronted with situations where assets subject to forfeiture are associated with its investigative activities. Unlike the Department of Justice and Department of Treasury, with which OIG frequently conducts joint investigative efforts, and unlike other statutory OIGs such as the Department of Agriculture OIG or the Department of Defense OIG, the HUD OIG does not have the authority to retain awards for investigative or audit costs under various remedial statutes. It would be helpful to obtain the same legal authority as our law enforcement partners to participate in existing federal asset forfeiture programs. Other agencies have invited us to claim in the liquidation of forfeited property but we must turn them down for lack of statutory authority or turn it over to another agency as we did with the Postal Inspection Service. We thank the Subcommittee for asking us to address any ideas we may have and appreciate such consideration.

Lastly, we would like to note, and emphasize, that we are pleased to be partnering with the FHA in a marketing endeavor to increase the general public's awareness of departmental anti-fraud activities and enhance education through better outreach activities, and to heighten efforts aimed at fraud prevention and at fraud reporting. The HUD OIG is launching a new website,

[www.mortgagefraud.gov](http://www.mortgagefraud.gov) , and with the FHA will be using this, as well as other avenues, to better publicize our hotline and activities. Below is the new HUD OIG brand insignia that will accompany our marketing effort to reach the public.



## **Conclusion**

As can be deduced from reading through the totality of issues raised in this testimony, a number of cross-cutting concerns transverse many of the highlighted FHA processes. These include: A) inadequate quality controls; B) reliance on manual processes; C) over dependence on the honesty of program participant(s) to provide accurate and truthful information; D) tendency to focus on entities rather than individuals; and E) the need to work more with the mortgage industry to better capture data on individuals involved in the process. Further, although not within the control of the FHA, the fact that our nationwide mortgage lending system is fragmented with separate players embracing differing requirements creates opportunities for waste, fraud and abuse that a more unified approach could potentially ameliorate. We very much look forward to the implementation of the new secretarial efforts designed to mitigate many of the difficulties we have been highlighting in the last number of years and to working with him and the Department to try to improve programs so increasingly relied on by our citizenry during these trying economic times.

In conclusion, though the challenges and tribulations are increasing, the Office of the Inspector General stands ready to assist in whatever way is deemed necessary and will be vigilant in its efforts to protect the funds of the American taxpayer. We thank you for the opportunity to relay our thoughts on these important issues based on the body of our work and of our experience, and greatly appreciate the activities of the Congress to protect the Department's funds from predatory and improper practices and to ensure an effective response on oversight at this critical time.