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Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for inviting me to testify today. I very much appreciate the opportunity to testify on behalf of the Inspector General on the important issue of FHA oversight of loan originators.

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 $30+ billion annual budget and, in the case of FHA, through mortgage insurance premiums.

The Committee asked that we provide an overview of recent changes to the FHA program, an assessment of FHA requirements and needs, identify any issues of importance, and detail any ongoing or planned OIG work in the area. We have recently stated in correspondence 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 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 keenly interested in FHA's ability and capacity to oversee the newly generated business.

The 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. 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 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 limited, the FHA was authorized to guarantee $300 billion in new loans to help prevent an estimated 400,000 homeowners from foreclosure. It also authorized changes to the FHA's Home Equity Conversion Mortgage (reverse) program that will enable more seniors to tap into their home's equity.

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 October 2008, show that FHA's total endorsements have increased from 21% of the market the year before to 76% of the market which includes both home sales and refinances. FHA's home sales' market share has increased from 6.4% to 23%. 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 may not be able to handle its expanded workload or new programs that require the agency to take on riskier loans then it historically has had in its portfolio.

FHA Resources

It is our understanding from the Department that funding for 22 staff positions and approximately $20 million for system improvements have been made available for the Hope for Homeowners program. They further tell us that they have limited resources for other newly-instituted modernization initiatives and that while they did receive a modest amount to be used for the administration (by the Office of Community Planning and Development) of the Neighborhood Stabilization Program, that funding must also be used for other disaster assistance needs**.** As you are aware, the Department as a whole has had significant new responsibilities over the last seven years in rebuilding communities devastated by disasters (i.e., lower Manhattan post-September 11th; the Gulf Coast region after hurricanes Katrina, Rita and Wilma; the Galveston area after recent hurricanes; California fires; and Midwest flooding) that have added approximately $30 billion in new program funds that require quick distribution and important oversight.

FHA tells us that they are reprogramming other funds to try to address modernization requirements. Yet, it remains very tight particularly as it relates to oversight. For example, the mortgage licensing provisions contained in the new legislation set minimum standards for nationwide licensing and a registration system for mortgage broker and loan officers. We have recently been told that there is one FHA person in the RESPA (Real Estate Settlements Procedure Act) unit who is assigned to work with the States in complying with this new regulatory requirement.

We continue to believe there is a critical need for more resources for FHA: 1) to enhance its IT systems; 2) to increase its personnel in a way to deal with an 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 in all critical front end issues including such important areas as the appraisal and underwriting processes.

While not the focus of this hearing, 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 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 a large proportion of the Hope for Homeowners and Home Equity Conversion Mortgage (HECM) Single-Family loans. Like FHA, Ginnie Mae has seen an augmentation in its market share (it had a 39% market share for the month of October 2008 surpassing 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) and it too has stretched and limited resources to adequately address this increase.

Despite all these enumerated issues, we are gratified that a new penalty provision was inserted into the Housing and Economic Recovery Act. 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 for committing fraud against FHA programs, similar to the predicates established in the Financial Institutions Reform, Recovery and Enforcement Act legislation, and will be a useful tool for prosecutors and the law enforcement community to employ in order to address those who would seek to harm the program.

OIG Observations

The results of the latest actuarial study 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, the fund's economic value was an estimated $12.9 billion, an almost 40 percent drop from over $21 billion a year ago. The current $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 the same time last year. 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 it has paid premiums to the fund, which has covered its fluctuating defaults and foreclosures.

The largest problem facing FHA, and the lenders it works with, is the fallout from decreasing home values. About 6.5 percent of FHA loans are currently in default. This 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.

Continuing OIG Audit and Inspection Concerns

We continue to focus our audit and inspection resources on the Single-Family program and point out where weaknesses or deficiencies need to be addressed. Among many different areas that we have reviewed, we have found that FHA needs to improve its internal control structure by formalizing risk assessments of its programs and its administrative functions and by conducting ongoing management control reviews. It also needs to establish a comprehensive strategy regarding its risk-based monitoring of program activities and participants and identify corrective actions required to improve its management controls in a timely manner. In another area, our audit of the FHA appraiser roster identified weaknesses 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. Moreover, results from a number of other key audits have noted significant lender underwriting deficiencies, inadequate quality controls, and other operational irregularities.

Additionally, we note that FHA’s lender approval process is largely manual. 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, and again, manual processes by contractors to select for review about one in every 20 loans or approximately 5 percent. 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.

Further, we have recently initiated an inspection 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. 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. The Departmental Enforcement Center is responsible for case preparation and referral to the MRB for final decision on sanctions.

Specifically, our review will determine the timeliness of decisions; evaluate controls over the mortgagee referral and enforcement processes; summarize data gathered on settlement agreements and collections; and provide an objective basis to comment on the effectiveness of the MRB as a regulatory body. We are looking into issues such as the types of penalties assessed; whether the penalties were mitigated to administrative payments; the sizes of the mortgagees brought before the board; the elapsed time from referral to board action; whether indemnification was required; and whether the mortgagees were repeat offenders or their principals were under limited denial of participations or debarred. We anticipate completion of this review in a few months.

Our audit work also highlights how problem lenders may regain admission into the FHA program even when previous transgressions were apparent. For example, we looked at 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 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.

Continuing OIG Investigative Concerns

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 lender approvals 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. Open applications received so far for FY 2009 total 1007 of which 827 have already been approved. The integrity and reliability of this crop of program loan originators, in our view, is unproven and, in light of the aggressive recent history of this industry, may pose a risk to the program.

In addition, FHA is now, due to loan limit increases, serving new metropolitan areas with which it previously has had little interaction. With such entry, come new players and unknown hazards. Simultaneous to this confluence of events, is an increase in the reported incidents of mortgage fraud. Mortgage fraud incidents reports, as compiled by the Mortgage Asset Research Institute, have increased by 45 percent in the second quarter compared to a year-ago period.

Like the Arizona example cited above in our audit concerns, we also have seen on the investigative side 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, sought and received an injunction against them in order to stop the business from operating. Following the injunction, FHA withdrew their lender approval.

In the area of foreclosure recovery, 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].

Another area of concern is the growing Home Equity Conversion Mortgage program. As an internal matter, in 2007, FHA's independent auditors identified a significant deficiency in the financial statement audit that showed the program being supported by a combination of servicer-provided applications, vendor databases, modification of existing FHA legacy systems and manually performed input to the FHA's general ledger. From an external standpoint, we are aware that the larger loan limits can be attractive to exploiters of the elderly, whether it is by third parties or by even 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 or even fraud by counseling entities. We are working with the Chairman and members of the Senate Committee on Aging to address some of their concerns regarding these issues.

Some HECM-related fraud activities involve flipping where an investor 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. Another activity that we currently have under investigation involves financial professionals convincing HECM borrowers to invest HECM proceeds in a financial product such as an annuity. 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. We have been partnering with the AARP and other groups to foster consumer protection education awareness. We are also a key participant in the mortgage fraud task forces nationwide coordinated by the Department of Justice.

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 impressions based on the body of our work and greatly appreciate the activities of the Congress to protect FHA's funds from predatory and improper practices and to ensure an effective response on oversight of the lender community at this critical time.