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BEFORE THE
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
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Statement of Kenneth M. Donohue, Inspector General
Department of Housing and Urban Development
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Chairman Dodd, Ranking Member Shelby, and members of the Committee; thank you for inviting me to testify today.

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 Office of Inspector General (OIG) has forged a strong alliance with HUD personnel in recommending ways to improve departmental operations and in prosecuting program abuses. 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.

One of the largest home mortgage insurers in the world, FHA has provided coverage to over 34 million homes since 1934. Its Single Family programs include insuring mortgage loans to purchase new or existing homes, condominiums, manufactured housing, houses needing rehabilitation, as well as offering reverse equity mortgages to elderly homeowners. FHA insurance protects HUD-approved lenders against losses should a homeowner default on their mortgage loan.

However, in recent years, what may be called a paradigm shift in mortgage lending practices has occurred with devastating impact on FHA market share and its traditional mission. Conventional mortgage lenders, both prime and subprime, offered financing options that attracted low-to-moderate income, first-time, and minority borrowers. These borrowers had previously looked to FHA loan products to buy their homes. Instead, they found that conventional mortgage lenders offered loan products featuring flexible payment and interest options, high loan-to-value (LTV) ratios, and relaxed underwriting guidelines. As a consequence, low-to-moderate income and other borrowers have decreased their usage of FHA's products; FHA's market share in terms of numbers of loans fell from 19 percent in 1996 to 6 percent in 2005, with almost all of the decline since 2001. Strikingly, this decrease also affected the very underserved communities FHA has previously seen in its special mission: FHA lost 35% of its Hispanic borrower market, 27% of its African American borrower market, and 25% of minority borrowers overall.

OIG Efforts

Based upon our review of modernization proposals, we think that one aspect of FHA reform that is lacking is ***oversight and enforcement***. With the exception of a single provision in one of the House versions of modernization reform, which expanded one of HUD's Civil Money Penalty statutes, none of the proposals, including HUD's, address oversight or enforcement in a substantive way. Our semi-annual reports make clear that fraud is prevalent in the Single Family program, and, thus, any reform proposal should, we believe, consider such provisions. Our collective work in both auditing and investigation underscores the need for strong FHA oversight. I believe that it is important to highlight for the Committee the history of our OIG efforts to show where we are now in order to understand where we may go.

Single Family Fraud

We continue to compile evidence through our audit and investigative activities of organized groups and individuals who scheme to take advantage of first-time homebuyers and minority customers. These groups and individuals conspire, with or without the borrowers' knowledge, to provide materially false applications, documents and statements to obscure information that would otherwise demonstrate that borrowers do not qualify for the loans they seek or that the property in question does not meet FHA insurance guidelines.

We are also seeing a trend with organized groups in some parts of the country recruiting undocumented aliens to purchase FHA-insured homes. Undocumented aliens are not qualified to purchase FHA-insured homes due to their immigration status. As a result, this group is often preyed upon by unscrupulous mortgage professionals who assist them in obtaining fraudulent and stolen social security numbers, tax documents, and employment documents. All too frequently these borrowers soon realize that they are unable to bear the recurring costs associated with homeownership and default on their loan. In turn, these ever increasing defaults degrade entire communities where the organized groups target their efforts.

Gulf Coast

Congress estimates that damage to residential structures will range in the billions of dollars. The devastation caused by Hurricanes Katrina, Rita, and Wilma, and more importantly, the unprecedented volume of Federal assistance provided in reaction to the hurricanes, has created an environment ripe for fraud. FHA Single Family program potential insurance exposure includes more than 328,000 mortgages with an unpaid principal balance of $23 billion. The HUD OIG will continue to focus, to the greatest extent possible, on the ultimate disposition and accountability of Single Family insurance claims against the FHA fund.

These practices could be prevented to a large extent by simple information sharing, that could be authorized as part of FHA reform legislation. Since Single Family loan origination fraud frequently involves false statements regarding the identity and income of borrowers, we believe that an automated identity/income verification system similar to that utilized by HUD's Enterprise Income Verification (EIV) program may prove useful in preventing FHA mortgage insurance fraud. Specifically, as HUD secured in the EIV program, we believe that FHA should pursue legislation to gain limited access for FHA-approved mortgagees to the National Directory of New Hires.

We envision an arrangement whereby FHA would obtain three data fields (e.g., name, Social Security number, and income) from the directory, and then make these data fields available to FHA-approved mortgagees via an encrypted Web-based system. As a condition of insurance endorsement, FHA-approved mortgagees would be required to access the Web-based system, verify prospective borrower identity and income, and resolve any discrepancies. The EIV has surpassed expectations of fraud prevention and detection in HUD's public and assisted housing programs, and we believe that this proposal could substantially prevent fraud in FHA's Single Family mortgage insurance program.

Examples

Over the past 3 years, the OIG has issued 190 audit reports in the area of FHA. These FHA-related audit reports identified over $1.1 billion in questioned costs and funds that could be put to better use. During the same time period, the OIG opened 1,078 mortgage fraud investigations. The following represent a sampling of some of the types of fraud we encounter in the FHA program:

Charlotte, North Carolina

Seven Charlotte residents were indicted by a federal grand jury on 66 counts relating to conspiracy, wire fraud, bank fraud, making false statements and entries, and money laundering. The Defendants owned and operated a mortgage brokerage corporation. The scheme entailed defrauding HUD and the Government National Mortgage Association (GNMA).

The Defendants executed an elaborate mortgage fraud scheme to generate over 100 loans that were purported to be FHA-insured loans on nonexistent properties. GNMA was required to make the investors whole when the fraud was discovered. The defendants would recruit strawbuyers to secure fraudulent FHA-insured home loans through a builder and these loans, in most cases, were secured by properties that were vacant lots or for homes belonging to legitimate homeowners. The Defendants received the loan proceeds and used the money for their personal benefit and to advance the fraud scheme. This investigation has resulted in the seizure of assets worth $8 million.

Detroit, Michigan

The OIG investigated a large mortgage company in Detroit and found that it submitted to FHA as many as 28,000 loans with underwriter's certifications purportedly signed by one of two FHA-approved underwriters. However, the loans were underwritten by other staff- not FHA approved- who merely signed the underwriters' names on the certifications. OIG referred the matter to the United States Attorney's Office for the Eastern District of Michigan, which entered into a civil settlement valued at in excess of $40 million.

Baltimore, Maryland

The OIG has operated a Housing Finance Fraud Task Force in Baltimore for several years in response to Senator Mikulski's concerns about predatory lending focused in this area. Forensic auditors and investigators have been instrumental in stemming 'flipping abuses' in the City of Baltimore and Baltimore County. For example, we initiated an investigation against a group known as the Bel Air 'flippers,' in reality a practicing title attorney and his investor/real estate agent conspirators who defrauded mortgage lenders on scores of properties that were quickly resold to strawbuyers at exorbitant profits. FHA and conventional loans were both exploited by these individuals. They were convicted, incarcerated, and ordered to pay restitution for their crimes.

Risk Mitigation and Fraud Deterrence

Over the last two years, FHA has made changes to its operations to increase efficiency in the processing of loans for insurance endorsement. Higher performing lenders now can endorse loans for FHA insurance without prior review by FHA. FHA appraisal requirements now mirror those of conventional market appraisals. Eligibility criteria for FHA loans in the hurricane-impacted Gulf States have been relaxed. These are just a few examples of how FHA has actively deregulated its programs to compete with the private sector.

A remedy to reduce fraud in mortgage loan programs is in the emergent stages. Mortgage bankers are beginning to use predictive models that screen loan applications for fraud at pre-funding. FHA needs to move beyond post endorsement monitoring and embrace this new technology through policy and programmatic changes, as part of FHA reform.

I want to emphasize that the Office of Inspector General is committed to working collectively with FHA management to deter fraud and abuse of its Single Family program. We also want to provide support to the Mortgage Bankers Association in this effort. In 2006, the Mortgage Bankers hosted a fraud symposium, which we attended and were an active participant. We hope such collaboration will continue to serve as a model for all our future cooperative efforts.

The Reform Challenge

Your invitation letter asked that I address and state my views on HUD's proposals for modernizing FHA. FHA reform is about recovering market share, competing on a level turf with private sector mortgage lending, and improving the financial solvency of the Mutual Mortgage Insurance (MMI) Fund. Our reading is that the reform is not about offering a way out of trouble, despite the headlines in the news lately, for those borrowers with high loan-to-value conventional and subprime loans in foreclosure.

I spent seven years at the Resolution Trust Corporation as Assistant Director for Investigations, uncovering the fraud and abuse among directors of the failed savings and loan institutions. I have seen first hand the damaging results of a solely profit-driven industry, which ultimately cost the American taxpayer billions of dollars. With the current trend of rising interest rates and the resulting payment shock as adjustable rate mortgages reset, coupled with low home appreciation, we can expect to see increasing delinquency and foreclosure rates for some time.

As a mortgage insurer, FHA pays the ultimate cost of loans that go bad. Lenders are made whole, but FHA seldom recovers that cost in reselling the properties to the public. FHA loses an average of 30% of each insurance claim it pays, when sales costs are netted against the payout to the lender/claimant.

FHA Risk

Does this scenario mean FHA faces an immediate financial crisis? Not based on the recent actuarial findings that estimate a capital ratio of 6.82 percent for the MMI Fund that well exceeds the 2 percent capital ratio mandated by the 1990 Cranston-Gonzalez National Affordable Housing Act. FHA actuaries found the MMI Fund to be adequately capitalized to defray expected claims over the next decade including losses from the hard hit Gulf Coast region, which is estimated at $613 million. Revenue shortfalls from insurance premiums were predicted, but these shortfalls were offset by expected interest income from Treasury investments.

This capital ratio was accumulated over a period of several years when the MMI Fund maintained a negative credit subsidy rate, meaning estimated cash inflows exceeded estimated cash outflows. However, FHA's FY 2008 budget submission casts a somewhat different light as it concerns the risk of the MMI Fund. It states: "*Because of adverse loan performance and improved estimation techniques, the base line credit subsidy rate for FHA's single family program—assuming no programmatic changes—is positive, <u>meaning that total costs exceed receipts on a present value basis, and therefore would require appropriations of credit subsidy budget authority to continue operation</u>. The 2008 baseline includes no budget authority to cover these costs and assumes FHA would* *use its existing authorities to increase premiums to avoid the need for credit subsidy appropriations. Under the Budget's proposals, FHA will be able to set premiums that are based on risk and are sufficient to avoid the need for credit subsidy appropriations."(emphasis added)*

Because FHA's FY 2008 business is projected to be riskier than prior years, FHA may be really left with only two choices: to request a credit subsidy by means of appropriations or to increase its premiums to avoid an estimated shortfall of $143 million in FY 2008.

FHA's response to this impending predicament is through the passage of FHA modernization reform. In earlier testimony, the FHA Commissioner stated, "…the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate risk. The proposed changes would permit FHA to operate like every other insurance company in the nation, pricing its products commensurate with the risk, as opposed to having some clients pay too much and some too little." I do note that some of the FHA reform proposals —which include zero-down payment loans, risk-based premiums, and higher mortgage limits—seem to be directed at expanding FHA's reach to the higher income housing market. A market reach, it may seem, that could go beyond its mission to serve the underserved: the low-to-moderate income family, the first-time homebuyer, and the minority borrower.

Zero Down Payment and Seller-Assisted Down Payment Assistance

We believe FHA should be wary of inviting future claim risks by insuring 100 percent and greater (after financing closing costs and insurance premiums) loan-to-value loans. If the proposal were to advance despite such sober concerns, prudent underwriting standards must be developed, loan performance tracked, and program modifications timely made, if these borrowers default at unacceptable rates.

FHA is currently experiencing higher default and claim rates on seller-funded nonprofit down payment assisted loans provided by Nehemiah, Ameridream, and other nonprofit organizations. These mortgages are effectively zero down payment loans (100 percent loan-to-value), because the sellers typically raise the price of the homes to cover the down payment amount. GAO reported in 2005 the probability of such loans resulting in an insurance claim was 76 percent higher than comparable loans without such assistance. It is reasonable to conclude that zero down payment loans could represent a comparable insurance risk.

The OIG testified before the House recently concerning seller-funded down payments. Our message was to strongly support HUD and FHA, and the proposed Rule (72 Fed. Reg. 27048 (May 11, 2007)), to effectively ban this practice in FHA lending. The current President of one of the largest seller-assisted down payment providers recently wrote an opinion piece that was published in the Wall Street Journal. He pressed that, in his view, we need to "send the Inspector General of HUD to charm school." While my wife would have objected to that assertion, I nevertheless cannot stress enough the importance of implementing the proposed rule, without material changes as part of FHA reform.

In 1999, we initially questioned the legal validity of the ‘nonprofit gift’ as a quid pro quo transaction rather than one made gratuitously without consideration, as fits the definition of a gift. The OIG has conducted substantial audit work at selected FHA lenders that approved loans with nonprofit down payment assistance. Three recent examples provide evidence of how these programs can adversely impact FHA borrowers:

> **America's Mortgage Resource, Inc.** (Audit Report No. 2006-FW-1006; March 28, 2006). A branch manager formed an identity-of-interest nonprofit entity to provide gifts for loans initiated by America’s Mortgage. However, this entity was never granted nonprofit eligibility by the IRS as its down payment gift program was determined not to provide a charitable service. Nevertheless, America’s Mortgage closed 73 FHA loans with down payment gifts through the entity, 38 percent of which were seller funded through increased sales prices. The markups ranged from $1000 to $13,000 depending on the cash needs of the borrowers to close the loans. The entity collected a 1 percent processing fee for each of the ineligible gifts.
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> **K. Hovnanian American Mortgage** (Audit Report No. 2006-FW-1004; January 26, 2006). In this case, a K. Hovnanian identify-of-interest homebuilding company provided gifts to nonprofits for loans underwritten by a K. Hovnanian lender that increased the sales prices of the homes. K. Hovnanian agreed to refund the fees inappropriately charged to the borrowers.
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> **Broad Street Mortgage** (Audit Report No. 2005-FW-1010; May 26, 2005). Audit testing of the lender’s loan files found documentary evidence showing that sellers increased sales prices to cover the cost of "donations" to down payment assistance providers. Correspondence between lender staff cited specific amounts needed from sellers to close the loan, the price markups required to fund the sellers’ ‘gifts.’

The results of these and other audits have validated our early findings on the overall program risk to the FHA insurance fund associated with nonprofit down payment assistance. In addition to specific audits of down payment assistance providers, we conducted comprehensive analyses looking in depth at these loans as they increasingly consumed a larger share of FHA loan originations. Our audit results concluded that HUD allowed nonprofit organizations to operate programs that circumvented FHA requirements. We found that the down payment loan transactions did not meet the intent of FHA requirements in that the assistance was not a true gift from the nonprofit; default rates for buyers receiving such assistance were significantly higher than for other FHA loans; and, sellers raised the sales prices of properties to cover the cost of the assistance programs causing buyers to finance higher loan amounts. We recommended that HUD implement a proposed rule to eliminate such programs and it is now in the rulemaking process. We have not been the only voice of concern. The Government Accountability Office (GAO) has repeatedly cautioned that FHA needed to better manage the risks of FHA-insured loans with down payment assistance.

Risk-Based Premiums

As I stated earlier in this testimony, FHA needs to be sure that a risk-based premium structure does not price out the availability of mortgage insurance to the underserved market.

FHA customers traditionally have been first-time homebuyers and minorities, some with credit history problems and marginal reserves to avoid default when facing financial stress. FHA reform will require these higher risk borrowers to pay higher premiums. Risk-based pricing, therefore, may increase the mortgage carrying costs of FHA borrowers that are the least able to afford them. Currently, all FHA-insured borrowers pay an up-front premium of 1.5 percent of the original loan amount, and annual premiums of 0.5 percent of the remaining insured principal balance. Lower-risk borrowers subsidize higher-risk borrowers under this level premium pricing concept. Administratively, the premium billing process is straight forward, the concept/billing readily understood by the borrower, and, most importantly, the collected premiums have been sufficient to maintain fund solvency since 1934.

Moving to a risk-based premium structure could also, by its very complexity, require increased budget authority to make FHA system modifications and impose new administrative/cost burdens on originating and servicing lenders. Further, it could potentially expose the FHA Single Family insurance program to fair housing questions and accusations of “red-lining” unless the decision matrix for pricing is unquestionable.

GAO’s recent analysis found that higher-risk borrowers who qualified for FHA insured loans under the level premium structure would have their loan applications rejected under this premium pricing. GAO estimated that approximately 20 percent of FHA’s 2005 borrowers would not have qualified for FHA mortgage insurance under the parameters of the risk-based pricing proposal they evaluated. It may be likely that such results, in the event that risk-based premiums are enacted, could prompt accusations of discriminatory practices on the part of both lenders and FHA.

Higher Mortgage Limits

In an assessment of the modernization proposal, one could argue that FHA appears to be strategizing to capture some share of the conventional prime market or borrowers who may not need a government program to acquire homeownership. Moreover, raising FHA area loan limits, especially in the high-cost area ones, may not necessarily help low-to-moderate income families become homeowners. In some markets, raising the base limit would mean that FHA would insure homes well above the median house price statewide, further potentially distancing FHA from its mission, and possibly exposing the MMI Fund to increased risk from regional economic downturns. If the limits for 2-4 unit properties are also included, FHA will be assuming even greater financial risk on what are essentially investment properties.

Combining Single Family Programs into the MMI Fund

The FHA modernization legislation contains proposals to move the 203k (rehabilitation), 234 (condominium) and the HECM (Home Equity Mortgage Conversion) loans into the Mutual Mortgage Insurance (MMI) Fund from the General Insurance (GI) Fund in order to consolidate all Single Family loans into one fund. The loans originated per month in the 203k and 234 programs are small compared to the loans originated in the standard FHA 203b program. However, the HECM loan program is significantly larger and could increase due to the cap being permanently lifted.

As stated above, FHA's base line credit subsidy for the Single Family program is expected to be positive in FY 2008 and would require either an appropriation or an increase in premiums. Moving these programs into the MMI Fund would improve that fund's overall subsidy rate. The Congress should be aware of the budgetary implications that this would have for the GI Fund and any need for additional appropriation. FHA officials told us that the largest of the three programs – the HECM program – has and will continue to receive a separate credit subsidy rate and that, therefore, the overall budgetary impact will be minimal. Nevertheless, the Congress should assure itself that any negative subsidies from the HECM program are not used to offset premium requirements for the standard FHA 203b program.

Conclusion

We continue to support the Department and FHA's mission. We will actively pursue fraud and abuse in FHA lending, regardless of whether changes are made to the FHA program. It is our mandate. We do recognize, however, that there are great challenges confronting FHA programs. Nevertheless, aggressive oversight and enforcement is crucial to prevent a recurrence of what we are witnessing in the subprime market today and the savings and loan industry in years past. It is the counter-balance that unfortunately is missing from the FHA reform proposal and I hope the Committee will consider as it contemplates its own modernization proposals. We would be available at the Committee's discretion to provide technical assistance if such support was needed.

That concludes my testimony and I thank the Committee for holding this important hearing and I look forward to answering questions that members may have.