

STATEMENT OF
SUSAN GAFFNEY, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BEFORE THE HOUSE SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY
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Chairman Roukema and other members of the Subcommittee, it is my pleasure to testify before you on the Inspector General's perspective on the health of the Federal Housing Administration's (FHA's) Mutual Mortgage Insurance (MMI) Fund. Accompanying me is James Heist, Assistant Inspector General for Audit.

Your other witnesses today can better answer technical questions about the economic value of the MMI fund, what capital reserve level is needed, and, most importantly, what these figures mean in terms of the future health of the MMI fund. I will defer to them to make assumptions about the future economic performance of the MMI fund. Other than pointing out two factors that need to be included in making such assumptions, I will be talking about Office of Inspector General (OIG) audit and investigation work in the Single Family Mortgage Insurance Program.

Need to Consider the Impact of Premium Changes and Loss Mitigation on the MMI Fund

One reason for the financial health of the MMI Fund has been the high insurance premium structure for FHA mortgages. Prior to 1983, the FHA Mortgage Insurance Premium was an annual charge of ½% of the outstanding mortgage principal balance. Today, FHA collects both up front and annual premiums. Until recently, most FHA loans included a 2.25% up front premium charge as well as an annual premium of ½% of the outstanding mortgage principal balance. Effective January 1st of this year, the up front premium dropped by a third to 1.50%, and significant changes were made to premium refund and cancellation policy. In fiscal year 2000, the FHA MMI fund's earned revenue was \$ 2,886 million. Unless there is a corresponding growth in FHA activity, this recent change in the premium structure will have a major impact on future revenue earnings of the MMI fund.

Another reason for the current health of the MMI fund is the increased use of foreclosure avoidance techniques. Two years ago we performed an audit of HUD's Loss Mitigation Program. We noted that the use of loss mitigation tools by lenders was growing exponentially. However, because of the newness of the program, there was no way for us to tell if the tools were working as intended. That is, did the use of the loss mitigation tool, such as restructuring the mortgage through a loan modification, actually have the intended effect of preventing the borrower from going into foreclosure? Or, did the loss mitigation merely delay the foreclosure process? We will be looking to answer

these questions in an audit scheduled to start later this year. GAO's report makes this same observation. If we find the program is not mitigating foreclosures, the future impact on the MMI fund in terms of future claims will be significant.

FHA Financial Audit

Earlier this month, we issued our report based on KPMG LLP's audit of the Federal Housing Administrations financial statements for the year ended September 30, 2000. KPMG expressed an unqualified opinion on these financial statements. However, KPMG also reported a potential non-compliance with the Anti-Deficiency Act, 31 U.S.C. 1341 (a), that requires additional analysis, as well as a policy or legal determination by HUD's Office of General Counsel, OMB and/or the Comptroller General. The report identifies a material weakness and three reportable conditions on internal controls. The material weakness involves the need for FHA to improve information technology systems to better support business processes. The reportable conditions include the need for: enhanced security over data, improved progress on early warning / loss prevention activities and better monitoring and accounting for single-family property inventories.

While the same material weakness and reportable conditions were included in FHA's fiscal year 1999 audit, we are seeing progress in each of these areas. Four reportable conditional in fiscal year 1999 are no longer reported in fiscal year 2000. Also, the fiscal year 2000 financial audit recognizes the potential concentration of fraud risk in certain geographic areas. The full impact of these fraudulent activities, which have been perpetrated against FHA, could be recognized as unexpected future claims and defaults against FHA's funds. These geographic areas of fraud risk have been identified by program staff and through an intensive effort by OIG staff to focus on FHA single-family operations over the past few years.

Summary of OIG Audit and Investigative Work

Aside from the financial audit, in the last few years our audit and investigative staffs have been actively involved in examining many aspects of the FHA single-family operations. We've identified origination frauds, property flipping scams and scandals in the sale of HUD owned properties. Needless to say, all these problems have an impact on the soundness of the MMI Fund. There are many factors beyond HUD's control—such as interest rates and unemployment rate--that affect the soundness of the MMI Fund. But assuring that programs are run efficiently and effectively and that programs are sufficiently managed to minimize the opportunities for fraud and abuse is within HUD's control.

As a result of a robust economy, FHA's MMI fund is financially the healthiest it has been in many years. But just because the FHA fund is profitable is no reason to tolerate program fraud. There are always opportunities to make things better. The FHA is a national treasure, built on a solid foundation. For more than 65 years, this

government program has helped real people meet their dream of homeownership. For many first time homebuyers with little or no credit history or for those unable to make large down payments, it was the FHA that made their dream possible. The FHA has a great reputation and many people look at FHA as the government's "seal of approval". Accordingly, we find it scandalous when program abuses result in defaults and foreclosures, harming the very people that the FHA program was designed to help.

While the present health of the fund is important, its long-term financial health is critical. FHA should take heed of the many warning indicators we see in our audits and investigations. It is important to keep in mind that a defaulted or foreclosed FHA insured mortgage resulting from poor origination practices that is originated today would take several years before it results in an FHA claim. Conversely, program improvements made today will take several years before they result in reductions in defaults and claims.

Problems Impacting the Financial Health of the MMI Fund

Flipping- Property flipping has become an increasing problem for the FHA. With flipped properties the MMI fund often gets saddled with insurance on an overvalued property. There's nothing inherently wrong with an entrepreneur buying a fixer upper property, making repairs and reselling it at a profit. What makes a property flip illegal is when there is something amiss in the transaction. When we see properties with FHA mortgage insurance bought and sold the same day for a 50% or 100% profit, we can be reasonably certain that something is wrong. In most cases, the profit results from false and fraudulent documentation provided by one or more of the parties to the transaction, such as the lender and/or the appraiser. In almost every case where we've seen a property flip, that is, a wide disparity between the purchase price and the resale price of a property, and a short turnaround between the two transactions—something illegal has happened. Unfortunately, these flips feed on each other, as the inflated value of one flipped property often becomes the valuation measure for the next property. Before long, these transactions have a devastating effect on neighborhoods.

We have numerous ongoing investigations involving single-family loan origination fraud, and specifically property flipping, throughout the United States. In our Housing Fraud Initiative locations, such as New York, Baltimore, Chicago, and Los Angeles, massive property flipping schemes involving FHA-insured mortgages continue to be uncovered. Flipping is increasing and has become a major problem for many communities. What is similar about these communities is the high volume of older decaying properties and an eager group of potential, often unsophisticated, low-income buyers who are anxious to achieve the American Dream of home ownership. In many cases we find that their dream of home ownership ultimately turns into a nightmare as their property begins to need major repairs and they discover that their property's real value is only a fraction of its original purchase price.

Last fall, in the Central District of California, we had one of our largest convictions for property flipping. Two co-conspirators were sentenced to a total of 134 months imprisonment, fined \$100,000, and ordered to make over \$2.6 million in restitution. The real estate scheme included duping more than 15 high school and college students, with previously clean credit records, into becoming buyers of flipped properties. The kingpin of this flipping scheme purchased at least 30 properties in the range of \$80,000 to \$100,000 each and then resold them at inflated prices of \$200,000 to \$300,000 each. These cases involved the use of forged documents to qualify the buyers for FHA insurance. Some additional properties were sold conventionally. To date, 28 FHA insured loans totaling over \$6,500,000 have gone into foreclosure. Six other defendants in this case have also signed plea agreements.

Early last year in Baltimore, Maryland, a property speculator, two loan originators, an appraiser and a settlement attorney were indicted for engaging in a prolific scheme to acquire inexpensive homes and fraudulently qualify buyers to purchase the properties at much higher prices. The vast majority of over 100 settlement statements for the purchase of these properties contained false information about the buyers' and sellers' monetary contributions to the transactions. Appraisals often overstated property values and misrepresented ownership at the time of the sale. Flipping was so prevalent in Baltimore that HUD put a moratorium on foreclosures.

Last June in Fort Lauderdale, Florida, a Federal grand jury returned an 11 count Indictment charging seven individuals with conspiracy to commit bank fraud, HUD fraud and false statements on more than 120 loan applications, most of them FHA-insured, totaling in excess of \$15 million dollars. The mortgage fraud was predicated on a flipping scheme. A real estate investor would purchase homes and, on the same day, resell them at inflated prices to unqualified buyers he had recruited. The buyers of these properties—almost always unsophisticated, first time home buyers and/or recent immigrants--did not have sufficient income or assets to pay the required down payment and closing costs, so the investor would illegally provide funds to them and incorporate these costs into the price of the over-inflated loans. A variety of fraudulent documents were used to make it appear that the buyers qualified for the loans.

Lender Oversight- A comprehensive audit of FHA loan origination practices issued early last year found significant problems with FHA's reviews of lender underwriting and property appraisals. Also, the monitoring of lenders by HUD's Quality Assurance Division was deficient. We noted problems with the oversight of pre-endorsement contractors, and the accuracy of information in the automated tracking system. These weaknesses increase HUD's risk of losses and can result in inflated appraisals, fraudulent underwriting, property flipping and other lending abuses. HUD's procedures for monitoring both lenders and contractors were less than effective, resulting in an increased risk of fraud, waste and abuse.

HUD's mortgage insurance risk depends almost exclusively on the reliability of work performed by its direct endorsement (DE) lenders that underwrite nearly all FHA insurance. HUD mitigates its risk through lender oversight. Three important HUD monitoring tools should be working to prevent the insurance of fraudulent loans: post

endorsement technical reviews of loan underwriting documentation, field reviews of appraisals, and quality assurance reviews of lenders. When used effectively, these tools can highlight problem loans such as property flips.

Post endorsement technical reviews of underwriting and property appraisals are key controls in monitoring direct endorsement lenders. These technical reviews are typically a desk review of FHA case documentation after insurance endorsement. These reviews assess lender compliance with HUD underwriting and appraisal requirements. Most of this work is contracted out with contractors paid \$15 to \$35 per case. If problems are found during these technical reviews, HUD is to take remedial action. HUD over relied on the work of these contractors and HUD was not reviewing contractor performance. The effects of such over reliance were demonstrated by a recent case where Allstate Mortgage Company fraudulently originated over 400 FHA loans totaling \$97 million. Seventeen of these loans had undergone post-endorsement reviews by a contractor. Although the 17 loan files showed obvious fraud indicators, the contractor found no significant problems. None of 17 cases had been re-examined by HUD contract monitors.

Our re-examination of 151 post endorsement reviews found that, in 70 cases, the reviews failed to disclose material underwriting errors. Our review found several reasons why HUD's controls over the post technical review process were not providing meaningful results, including:

- inexperienced staff in critical HUD control positions,
- increased loan volume with fewer staff to monitor lenders,
- no clear operating policies or procedures for Homeownership Center operations,
- outdated handbooks,
- emphasis on quantitative goals, and
- financial disincentives for contractors to find problem endorsements.

Another critical control is the systematic testing of property appraisals by HUD. The direct endorsement lender selects the appraiser that sets the value of the property for FHA insurance. With the high loan to value ratio of most FHA loans, an accurate appraisal is critical to minimizing HUD's insurance risk. HUD's procedures call for field reviews of 10 percent of all appraisals. Also, there are additional requirements that assure oversight of each appraiser's and each lender's performance and follow-up when problems are noted. During our audit we found that these controls were not being followed. Branch Chiefs at three Homeownership Centers commented that they did not have enough staff to monitor appraisers or to sanction poor performers. Since completing our audit, HUD has made significant strides in the area of improved appraiser oversight, by identifying high risk appraisers for review.

A third important control over direct endorsement lender activity is the on-site monitoring reviews to identify and correct poor origination practices. While the Quality Assurance Divisions should focus on lenders with high defaults and foreclosures, many

low risk lenders were reviewed in order to meet quantitative processing goals. HUD needs to assure that limited monitoring resources are used effectively.

REO Properties- FHA contracted for the management and marketing of its single-family properties in March of 1999. Seven companies received awards for the 16 M&M contracts to manage its single-family property inventory. The objective of the contracts was to reduce the inventory in a manner that: “(1) expands home ownership, (2) strengthens neighborhoods and communities, and (3) ensures a maximum return to the mortgage insurance fund.” FHA has realized some success from outsourcing. Sales volume increased and property inventories decreased. Also, contractors implemented new marketing tools such as bidding through the Internet. Sales of properties in fiscal year 2000 exceeded \$5 Billion.

However, our comprehensive audit of the program found that FHA’s contractors did not maximize the return to the mortgage insurance fund or maintain properties in a manner that strengthened neighborhoods and communities. FHA has had numerous other problems with the contractors, including bankruptcy by one, inability to meet contract performance deadlines, countless complaints from homebuyers and real estate professionals, and billings for ineligible costs. We found problems with all seven contracts reviewed. We computed the outsourcing of program operations to cost the MMI fund an additional \$188 million. We attribute this cost to poor M&M contractor sales performance and substantially increased program costs. We believe FHA’s failure to perform a cost benefit analysis in accordance with A-76 contributed to the poor program performance and loss of funds.

Officer Next Door (OND), Teacher Next Door (TND) Program- While this is a very small program, with fewer than 4,000 properties sold since its inception in 1997, it illustrates the difficulty of setting up boutique programs in HUD without sufficiently considering the staff resources needed to effectively operate them. As you know, this program allows police officers or teachers to purchase REO properties in designated revitalization areas at 50% of their appraised value. Our recently issued interim audit found a high proportion of homebuyers abusing and defrauding the OND/TND program. Seven of the 29 homebuyers we reviewed violated one or more program requirements, lenders were not executing second mortgages as required and HUD did not have an effective method of tracking suspected violations. This program reduces the recoveries on REO sales, thus impacting the financial health of the MMI fund.

What Are the Causes and Solutions?

When we become aware of a fraudulent transaction, we generally attempt to determine its cause. That is, what controls were not followed or what additional controls are needed to prevent it from happening in the future. Our investigations and audits of FHA-insured single-family loan originations have disclosed a number of common problems. First, many of HUD’s well established controls were not being performed or they were performed in such a perfunctory manner as to render them useless. Another

major contributing factor was HUD's 2020 Reorganization that 1) moved many HUD staff into new positions for which they had little if any training, and 2) consolidated all field operations into four Homeownership Centers. Lastly, in fiscal year 1998, HUD's single-family staff was cut in half. During this same time, FHA reached historic records of insurance activity. All these factors combined to make HUD particularly vulnerable to fraud.

Our New York Housing Fraud Initiative staff has been dealing with a major scandal in the 203(K) rehabilitation program in Harlem and Brooklyn. While the 203(K) program is part of the General Insurance Fund, not the MMI Fund, I bring this up because the cause of the problem is the same. Several non-profits fleeced HUD by getting hundreds of federally insured loans well in excess of the property value. The biggest contributing cause to this scandal was the lack of HUD staff to oversee origination practices.

FHA Single Family program staff are in the process of taking corrective actions on most of our audit recommendations. Further, we are pleased to see that the President's Blueprint for HUD is recognizing the need for FHA fraud reduction and improved program controls. The Blueprint will include actions to improve the loan origination process and provide for better monitoring of lenders and appraisers. Recognizing that HUD's single family staff have been through downsizing, reorganization, and heightened workload expectations, we need to step back and figure out how we can make the internal control requirements that are on HUD's books actually work to prevent fraud and abuse. Internal controls will not work without sufficiently trained staff to assure that checks and balances are in place. If the Congress and the Secretary of HUD send a clear message that that's what they really want, then I am confident that the single family staff will be able to figure out how to do it. The problem is, of course, that making internal controls work is generally perceived as a tedious endeavor. But that's how real work gets done.

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Chairman Roukema, I appreciate the Subcommittee's concern about the wellness of the MMI fund. The new Secretary's team and my staff have had discussions on improvements needed in the FHA programs and we are eager to work with this new Administration to make FHA better. I thank you for the opportunity to present the views of the OIG at this hearing, and I pledge our full support for your efforts to strengthen the single-family mortgage insurance program.