WRITTEN STATEMENT OF
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BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TRANSPORTATION, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES
UNITED STATES SENATE
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Chairman Murray, Ranking Member Bond, and members of the Subcommittee, thank you for inviting me to submit written testimony today. I very much appreciate the opportunity to speak on the importance of the role of the Federal Housing Administration (FHA) in addressing the housing crisis currently confronting our nation. It was a year ago, when I last testified before you on this topic and much has transpired during the intervening time as well as some aspects, such as the stagnancy of the housing market, unfortunately remaining the same. We have not yet weathered the economic storm but hopefully in its aftermath we will see some clearer skies and renewed prosperity. This much is known one year later however – the current degree of FHA predominance in the market still is unparalleled.

Background

The mission of the Department of Housing and Urban Development (HUD) is to increase home ownership, support community development, and increase access to affordable housing free from discrimination. The FHA provides mortgage insurance to private lenders that finance single family homes, multifamily projects, healthcare facilities, loans for property improvements and manufactured homes. The FHA has provided mortgage insurance to over 37 million single family homes and over 51,000 multifamily projects since its inception over 75 years ago. Most of the industry has adhered to the FHA and industry standards in assisting the American homebuyer. Unfortunately, there are those that seize upon the opportunity for "greed" in exploiting the system.

As I stated previously, the last number of 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 arguably drawing comparisons to levels of distress experienced in the Great Depression; 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.

The FHA was established under the National Housing Act of 1934 to improve housing standards and conditions, to provide an adequate home financing system by insuring mortgages and rental projects, and to stabilize the mortgage market after the devastation of the Depression and massive losses of homeownership during that time. It was created to be the standard setter and the standard bearer for the mortgage and housing communities in areas such as underwriting standards and ethical behavior. It had, in my estimation, as history will attest, abdicated this important role -- too often slow on the upside, as we saw during the recent expansion of FHA in the marketplace, and slow on the downside. It had a responsibility which frankly it sidestepped.

Historical Perspective

The FHA Commissioner in his testimony a number of weeks ago regarding policy and legislative reforms, stated that "…many of these reforms were long overdue as FHA did not respond effectively to changes in the marketplace that happened during the housing boom and the subsequent decline." In his view "…inaction was and is not an option." I applaud these remarks and state for the record that in my eight years as HUD Inspector General, this FHA

Commissioner has tried to do more in the last year than I saw in all the previous years combined. As you know from my many years of testimony before this Subcommittee and others, I agree with his statement that the "organization they inherited was simply not properly managing or monitoring its risk." Many of his proposals and initiatives are long overdue and meritorious. That said, we still have much to do and have much uncertainty facing this Department -- some within the control of departmental officials and some outside their sphere of influence. While it is difficult to predict the future -- as an old adage goes if you have five economists in the room you'll have eight different forecasts -- I am not as optimistic as some are with where we are today or even going in the near future but I do agree that the program is attempting to move ahead in a good direction.

In late 2008, a BusinessWeek article generated a buzz with a picture of a wolf on the cover representing the pernicious side of the mortgage industry coming at the FHA. I was quoted at the time expressing my concern about the groundswell of loans that were going to come in to the program and the types of loans that might be coming with the onslaught of new lenders. The FHA disputed my statements. Also quoted in the article was Michael Ashley, a chief official of a New York mortgage lending firm who had switched its strategy from subprime to FHA-backed mortgages. The article reported that in 2008 alone the company, Lend America, made $1.5 billion in loans and Ashley is quoted as stating that the "FHA is a big part of the future." I was perturbed reading his blatant bravado regarding how the FHA had become his meal ticket because of our open investigation of him and his company at the time and our previous prosecution against him years earlier for engaging in similar activity.

When I highlighted this case to you in previous testimony, I was frustrated with the vulnerabilities in the FHA approval system that allowed Mr. Ashley to come back into the program and to publicly and brazenly brag about his participation. I am pleased to state, however, that we did receive an injunction against Mr. Ashley banning him permanently from ever engaging in federal mortgage programs. A local newspaper reported when we took initial action against him that there was a Mercedes Benz car in the company parking lot with a license plate "RefiFHA." Hopefully, with the actions that the FHA is trying to put into place today we will not see such bombastic industry behavior. I am also pleased that this Commissioner has recently taken action against over 300 lenders sending a very distinct message to the lending community. I had highlighted in reports that the Department's Mortgagee Review Board was broken and I applaud his action to reinvigorate the process. I do think that this Commissioner is dealing with the consequences of departmental inactions that took place prior to his tenure and that our perceptions at the time have, despite the agency's attempts then at refutation, come to pass in terms of volume, types of participants, and ramifications to the portfolio.

For example, another recent OIG case underscores large fraud schemes and losses to the program. At Taylor Bean and Whitaker (TBW) Mortgage Corporation and Colonial Bank we uncovered various schemes. Federal search warrants were simultaneously executed at both TBW and Colonial Bank. The FHA then suspended TBW from participation and the company filed for bankruptcy. Colonial Bank was taken over by the FDIC and then sold to BB&T Bank. HUD's suspension was based on TBW failing to submit an audited financial statement, misrepresentating that there were no unresolved issues with an independent auditor and its failure to disclose it was the subject of two examinations into its business practices. At the point of seizure, TBW was servicing federally insured and guaranteed loans with a remaining principal balance of about $26 billion.

Lastly, I had said 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. Some of these were long-standing concerns that went back to unresolved issues highlighted in our work products from as far back as the early 1990's.

The Current Landscape

The past two years have certainly produced a lot of changes and initiatives. In response to increasing delinquencies and foreclosures brought about by the collapsing subprime mortgage market, the FHA Secure program to refinance existing subprime mortgages, the Housing and Economic Recovery Act's (HERA) Hope for Homeowners program, the Helping Families Save Their Homes Act, and The Making Home Affordable Program were created to assist homeowners.

As we turn to today's environment, the size of the Single-Family FHA-insured loan portfolio has enlarged by nearly 50 percent from $466 billion in Fiscal Year 2008 to over $697 billion in Fiscal Year 2009. During the month of March of this year, the FHA's total mortgage in force was over 6.1 million with an aggregate outstanding balance of over $800 billion. Single-Family market comparisons from the first quarter of Fiscal Year 2010 show that FHA's total endorsements have increased to 74 percent of the insured mortgage market which includes both home sales and refinances. As recent FHA testimony states, the FHA program is insuring almost 30 percent of purchases and in the past year alone helped more than 800,000 homeowners refinance.

I still remain concerned that the 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 overtaxing the current infrastructure, making careful and comprehensive lender monitoring difficult. Through our cases we see the consequences of allowing in dubious lenders who then inflicted the program with problematic loans. In addition, our experience in prior high FHA volume periods (such as from 1989-1991 and 1997-2001) shows that the program was vulnerable to exploitation by fraud schemes, most notoriously flipping activities, that undercut the integrity of the program. I support many of the recent initiatives proposed by the Secretary and the FHA Commissioner, of which I will elaborate on later, and a new departmental attitude to address these issues head on.

We testified last year that the FHA had to contend with a significant and complex situation in balancing the risks to, and fiscal vitality of, the Mutual Mortgage Insurance (MMI) Fund against the need to assure financial mortgage markets continue to function properly during the downturn of the economy. Among the issues we spoke to were the adequacy of resources available to

FHA for staffing, training, oversight, and system enhancements. We cited the increasing risks the FHA faced that needed to be addressed by both its front-end risk assessment processes as well as its back-end monitoring and corrective action processes.

Since that time the FHA has undertaken a number of actions to mitigate some of those risks and protect reserve fund balances. The FHA has banked on the accuracy of its actuary's projections in assessing the health of the Fund and has faith that it is experiencing improved performance with its 2009 and 2010 portfolio. Economists cannot agree the direction the economy is going and I equally am not a proficient prognosticator. We are in a fluid and dynamic situation that too often has not been predictable or readily knowable. The FHA, like the average American, is still searching for clearer horizons and a break in the tempest.

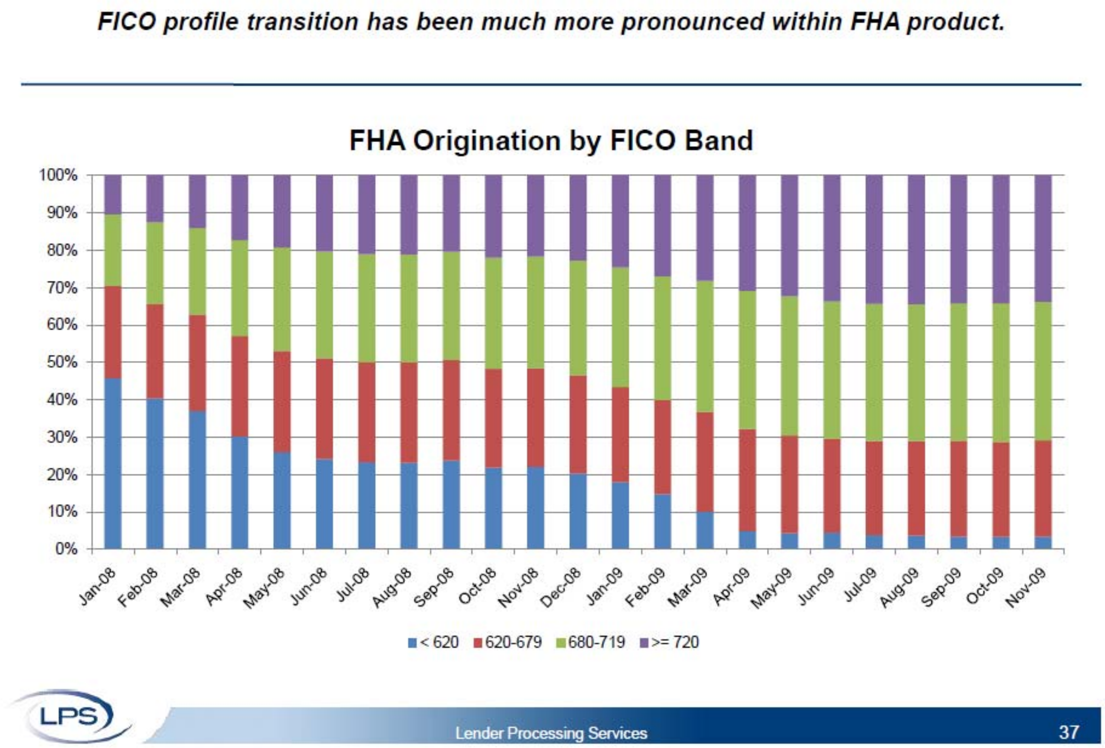
The FHA's latest report shows that for last quarter, the net losses on claims were averaging close to 60 percent which is 13 percent higher than was predicted. In layman's terms, the FHA is recovering only 42 cents on the dollar (i.e., what it loses after it pays a claim and sells foreclosed property). In the State of Michigan, however, it is only recovering 16 cents on the dollar. It currently has approximately 45,600 properties at a value of $5.7 billion in the real estate owned (REO) inventory. Moreover, its credit subsidy rate is one half percent which after adjustment for present value means revenues are a half percent ahead of claims. That's positive but by a very slim margin. The FHA is taking a number of steps to mitigate losses and keep the fund positive.

While the FHA's confidence in actuarial numbers brings it hope, we believe vigilance is needed until the marketplace has stabilized. Like any American family in today's uncertain times, the FHA will have to continuously monitor its financial position and take proactive steps to keep ahead of the curve when reality dictates corrective action is required. The FHA has a number of tools at its disposal to increase revenue or to reduce losses accomplished through mechanisms such as loss mitigation or vigilant oversight of lenders and brokers. Most of the major actions proposed to mitigate risk will not go into effect right away so we need to understand that such actions may have little effect on loans already in the portfolio. With the current state of the economy, will there be enough new loans to bail out the old loans? This is where due diligence today is imperative as well as an overall proactive approach.

FHA Policy Changes to Address Risk and Strengthen Finances

1. ***New loan-to-value and credit score requirements***:
Loans to borrowers with a credit score of less than 580 will require a minimum 10 percent down payment. Loans to borrowers with a credit score of 580 or above will require the traditional minimum of 3.5 percent down payment. This change, if approved, will go into effect this summer after going through the Federal Register notice and comment process.

We are in general agreement with the move to strengthen down payment requirements. We, however, believe there are some caveats. While this requires borrowers with the riskiest loans (below 580) to put more, to quote an earlier comment by Senator Bond, "skin in the game," this will more than likely have minimal impact on the Fund in terms of bringing in additional premiums. Loans for borrowers with credit scores below 580 are less than one percent of new activity. So these additional requirements may likely end most activity in this category. It might, however, reduce future claims but the volume of these loans will not bring in a significant amount of premium payments to cover current losses. The chart below from LPS Applied Analytics shows the proportion of FICO credit scores over the last 23 months.



Information provided by LPS Applied Analytics

As seen in the lowest color segment of the bar chart for FICO scores below 620, the percentage of loans that would be potentially subject to the new 10 percent down payment requirement has steadily decreased to less than one percent. This is both good news and bad news because it shows that from a financial perspective the FHA’s riskiest business is falling off but from a social perspective the potential homeowners that it traditionally has served may be priced out of the market. Importantly, we are also seeing defaults and claims affecting higher credit score loan holders and there are some vocal advocates who think a higher down payment may be required for a wider spectrum of credit score categories. Further, the 580 credit score threshold is well into what is traditionally considered subprime territory in the conventional marketplace with 620 being the usual demarcation for subprime. We believe that to have a higher down payment requirement at the 620 level may have a more meaningful impact due to the larger volume of loans at this level.

In assessing the most recent year’s book of business, it needs to be understood that underwriting is like a three-legged stool. FICO scores are only one leg -- the other two legs are the value of the property and the future employment of the borrower.   While it is true that FICO scores have risen from an average of 626 in FY 2008 to 695 in the first quarter of FY 2010, we should also note that the loan-to-value ratios have also gone up during this timeframe. In FHA's recent Quarterly Report, the loan-to-value ratio for the 96-98 percent category had risen from 48.8 percent of the loans written in the first quarter of FY 2009 to 69.1 percent in the first quarter of FY 2010. This may mean that any gains realized from reduced risk for having higher FICO scores may be offset by the increased risk of higher loan-to-value ratios. In other words, borrowers are putting less of a down payment into purchased homes. As we said in previous testimony opposing seller-funded down payment assistance plans, less "skin in the game" often means that there are increased chances for the owner to walk away if delinquencies occur. Further, any benefit from the increase in the average FICO scores may be tempered by a commensurate rise in claims generated from those loans.

So while the FHA believes that they may have an improved book of business in terms of increased volume and FICO scores, the jury is still out if the additional cash generated by the new book of business will be sufficient to cover the unknown amount of losses in the short term or if the premise that high FICO scores are equivalent to soundly underwritten loans still holds. Economic instability is creating counter-intuitive trends in consumer behavior.

2. ***Up-front mortgage insurance premium increased to 2.25 percent***:
The FHA is pursuing legislative authority to increase the statutory cap on the annual Mortgage Insurance premium. OIG supports this change in the premium structure. Any business needs to be able to adjust its pricing in order to continue to operate efficiently. The FHA needs the ability to adjust premium prices without requiring legislative action each time that may impede its ability to react quickly. The FHA will need, however, to ensure that a process is developed to link future insurance premium changes to actuarial forecasts.

3. ***Reduce allowable seller concessions from six percent to three percent***:
The FHA is seeking an action to conform to industry standards and to reduce potential value inflation. It is anticipated to go into effect this summer after appropriate notice and comment time. The OIG supports this measure. We believe that the FHA needs to be consistent with industry practices so as to avoid pressure to raise prices to cover seller concessions.

4. ***Increase enforcement efforts to ensure compliance with FHA guidelines and standards***:
The FHA: a) will use a scorecard system to evaluate and report lender performance to compliment current information available from Neighborhood Watch data (this was implemented in Mortgagee Letter 2010-03); b) will enforce indemnification provisions through section 256 of the National Housing Act and cover those loans found to contain material errors in underwriting (this is anticipated to go into effect this summer after posting and comment periods); c) asked for legislation to apply section 256 to require indemnification provisions for all direct endorsement lenders in order that all approved mortgagees assume liability for the loans originated and underwritten by them; and d) will move to increase capital requirements from $250 thousand to $1 million in one year, and then to $2.5 million after the final rule is published, and hold the lender responsible for the final underwriting.

We support the FHA's decision to enhance risk management by, among other things, hiring a senior level risk management officer. Its decision to use a scorecard system will certainly assist it in uncovering problem companies. We note that the FHA has returned to conducting a 5 percent sample of lender endorsement reviews by its contractors. The number had slipped to 2 percent last year because it could not keep up with the volume. We also support FHA's request for legislative authority to create separate areas for the purpose of review and termination under the Credit Watch Initiative.

The FHA's intent to strengthen enforcement of its indemnification provisions in section 256 is important to an overall enhanced enforcement strategy. OIG reviews of indemnifications found recovery was hampered by firms going out of business, thereby rendering some indemnifications worthless. In a recent OIG Inspection and Evaluation report, we found that the FHA serviced $187.5 million of indemnification and civil money penalty debt due from lenders for the period FY 2005 through FY 2008. The FHA collected $124.4 million or a 66% recovery rate (a collection rate that compares favorably with that of the Veterans Administration's Housing-Guaranteed and Insured Loans program and private collection agencies), however $8.7 million was uncollectable primarily the result of the debtor lender going out of business.

- **OIG Concerns Regarding Anti-Flipping Waiver**: One change the FHA recently instituted this year was the decision to waive its anti-flipping provisions for one year. This action was not vetted with us through normal departmental clearances and we, unfortunately, had no opportunity to opine on the matter. While we understand the underlying reasoning to turnaround foreclosed properties in a quicker manner, we believe its imposition may open a new round of fraud-related flipping abuse and we would have liked to express our concerns or to press for more compensating controls.

  Current housing market conditions have created a bulge in HUD's real estate owned inventories that provide a ready source of properties for potential flipping schemes. To eliminate inventories, lenders and the FHA's own contractors often significantly discount the sales price from acquisition costs and appraisal values in a more normal housing market. The discounts provide the necessary margin for flipping opportunities, legitimate as well as illegitimate. Historically, the illegitimate flip involved a conspiracy between investors, loan officers and appraisers, allowing for the financing of the re-sale to be done at an inflated value, justified by market conditions of increasing housing values.

  When the anti-flipping rule had been originally promulgated, the FHA, primarily at the request of the OIG, sought to protect the MMI Fund from this vulnerability by prohibiting financing of property re-sales until 90 days had elapsed after the purchaser acquired the property. This waiting period effectively protected the FHA from flip abuses such as "double escrows" and same day closings. The FHA states the waiver is designed to help reduce REO inventories. There is, however, a real risk that the waiver could serve as an invitation to investors willing to engage in abusive schemes or to try to skirt the rules. Indeed, we almost immediately saw discussions on the internet among investors. Moreover, with the increase in the FHA's loan limits to greater levels, high-end, as well as traditionally low-end, properties could be targeted by the unscrupulous.

  While an attempt was made by the FHA to mitigate improper activity by requiring an explanation of any price increase over 20 percent, as a law enforcement agency we know that it can be just as easy to fabricate documents for this as it can be to inflate the appraisal itself. We see little to deter the wide-scale flipping that occurred before the practice was stopped by a 90 day waiting period. While we recognize that keeping the status quo may delay closing, we believe that it is preferable to the alternative risk that such an action may unleash. A safer approach may be to limit the wavier to GSE-held properties or to those sold through State and local rehabilitation programs such as the Neighborhood Stabilization Program where closer scrutiny of rehabilitation costs can be made.

- **Enhanced Up-Front Reviews**: We believe it is important that the FHA become more aggressive in the areas of monitoring and detection and analysis of red flags. We endorse FHA's Mortgage Fraud Initiative which seeks to use fraud detection technology to identify loans likely to contain fraudulent information. We have stated previously our belief that FHA needs to take advantage of commercial off-the-shelf pre-screening loan software. We have also long voiced our concerns that the process to become an FHA approved lender and correspondent was not rigorous enough to keep out the known bad actors. When the conventional markets started to decline, we expressed our concern that the same individuals and companies that precipitated the conventional market collapse would seek shelter in the FHA markets and use similar tactics that led to poor underwriting. We believe that this did in fact occur.

  In the case which I referred to earlier in this testimony regarding the New York company Lend America, Michael Ashley, who carefully did not place himself as a principal in the firm but as a business strategist, had had a long history of legal troubles (including with the HUD OIG) and was working as a top manager for one of the most rapidly growing lenders in the FHA's portfolio. Court filings show that Ashley fostered an environment that encouraged sales staff to originate FHA loans even when the borrowers were not eligible. Sales staff could make ten times the commission on FHA loans than on standard mortgages and almost four times the commission than on a subprime loan.

  Mr. Ashley pled guilty in 1996 in federal court to two counts of wire fraud relating to a mortgage scam at another company his family once owned. He was sentenced to 5 years probation and ordered to pay a fine and his father was sentenced to nearly 4 years in prison. He appealed his suspension and debarment with HUD which later was reduced to a ban that expired in 1998. Once served, the FHA allowed him to resume operations. He then went to another firm that again HUD issued a notice of violation. After leaving that firm, he became affiliated with the most recent company. Although this case is still open, it is clear to say that the federal court would not have permanently banned Mr. Ashley if it were not concerned about the current operations of his affiliated company. The President of the company was also debarred at the same time but for a specific period of time -- in this case 18 months.

  This again calls for the establishment of a new mindset at the FHA to know your participants and not just the entity. It can be a very arduous process for the OIG acting as the investigators for the Department of Justice to work to get a court-ordered injunction. Mr. Ashley was quoted in the press as grumbling that the Inspector General's office tried its best to constantly go after him and put him out of business. Although he was complaining to the judge at the time, his quote is revealing in that we had to keep following him from one dubious enterprise to another. It can be frustrating. If current regulations and statutes are impeding the FHA's ability to create a watch list or to know its providers complete backgrounds or to keep out permanently those from entering whom it does not want to participate in its program - it has a duty to let Congress know it needs legislative relief to enhance its administrative remedies (i.e., more permanent debarment authority, enhanced civil monetary penalty fines) in order to accomplish this goal. I do not believe in years past, when it was striving to increase its market share, that this was a goal. But I do believe that with the large influx of loans and lenders coming at the program recently it may now see how imprudent such inaction can be.

A systemic weakness revealed in this case and others showed that FHA-related monitoring and oversight reports typically cited the lending firm without naming the individuals associated. The FHA had argued that without specific citations against individuals it could not link principals of a defunct company to those same individuals who would go on to form new entities. We see this type of maneuver too often and it makes the FHA program too easy a target for those intent on abusing the program. We recommend that FHA ensure in a more significant way that those individuals affiliated with lender entities (either as principals or as staff) are clear of indictment, conviction, debarment and suspension, limited denials of participation and unpaid federal debt before applications are approved.

The FHA should also consult with other HUD offices to determine whether applicants are subject to unresolved findings and ensure that application fees received are reconciled with the related applications. More importantly, if the Mortgagee Review Board concludes that a company has participated in improper activities and recommends removing the company's ability to participate in the FHA loan program, the Board also needs to recommend permanent removal of the principals and other individuals involved from any future FHA and HUD programs. I know in my conversations with the Commissioner this is an area on his radar screen.

The Commissioner testified at his recent hearing, and I lauded earlier in my testimony, that over the last year the FHA has withdrawn 300 licenses from poor performing lenders. We believe that many of these could have been screened more vigorously at the time of their application before the consequences of their admission came to bear in terms of losses or resources applied to investigate and to prosecute. Only time will tell how many more significant failures are yet to be uncovered but we do see more on the horizon. We believe that more stringent requirements, in addition to enhanced net worth requirements, are needed to keep predatory firms and individuals from conducting FHA business.

I would like to take the opportunity to also draw a parallel issue with the Government National Mortgage Administration (Ginnie Mae) approval process. We believe Ginnie Mae equally needs to strengthen its approval process. While the funding level for its reserves are in a better financial position than that of the FHA, it too has experienced increasing default rates and has suffered unusual substantial losses due to the failure of Taylor, Bean and Whitaker and Lend America. More due diligence needs to be done by Ginnie Mae in approving and recertifying its issuers and I look forward to seeing meaningful recommendations for statutory and regulatory improvements akin to what the FHA has recently proposed. It also has to shift its mindset away from a business-oriented mentality to let problem issuers remain in the program while they work out the details. This attitude toward the industry is no longer feasible unless it wants to absorb large losses. I will speak more to my concerns with Ginnie Mae later in the testimony.

We commend the FHA for endeavoring to expand its enforcement and note that it has very much needed to implement a more robust early warning system that would alert FHA to precipitous sales price increases. We also see the need for FHA to enhance its Neighborhood Watch system (i.e., allow for tracking of information relating to loan officers, loan processors, and real estate agents) and the Credit Watch Termination Initiative.

- **Lack of Affirmative Certification Statement**: In this same vein, we would like to update the Subcommittee on a matter we brought before you a year ago. At the time, I shared with the members an exhibit showing the current application form to become an approved FHA lender or Ginnie Mae issuer. I pointed out to the Subcommittee that unlike the Ginnie Mae section which contained an affirmative statement that required the applicant to attest that they had not knowingly made a false statement and could be subject to applicable civil or criminal penalties, and despite the large volume of new applicants coming into the FHA program, the FHA certification and recertification inexplicably contained no such requirement. Even more puzzling is the FHA's response from the Director of the Office of Lender Activities to my recommendation in an audit of the lender approval process. The FHA stated it did not agree with the finding and stated that "the OIG has not sufficiently demonstrated that because of its certification language FHA is unable to successfully take legal action against lenders violating its program requirements" and requested its removal from the audit.

  The Department of Justice as chair of the National Procurement Fraud Task Force has recommended that all agencies put in language for grantees of federal funds the requirement that the participant certify that the statements made in the application are true and correct and that it understands that any false statements made as a part of these certifications can be prosecuted.

5. ***Requirements to better manage brokers such as new rules for audited financial statements and adequate capitalization***:
OIG supports this initiative. We also believe that the annual financial statements for lenders lag too far behind to be useful. We believe there should be quarterly unaudited financial statements similar to the SEC's publicly-traded company requirement and suggest that there also be an effective review process of these statements. Billions of dollars flowing through the FHA are riding on the financial health of these firms. Timeliness of information is essential in making decisions and we would encourage such a change.

Operation Watchdog

On January 12, 2010, FHA Commissioner Stevens and I jointly announced a new OIG initiative focusing on mortgage companies with significant claim rates against the FHA mortgage insurance program. This initiative was prompted in part by the Commissioner who was alarmed by the incidence of excessive default rates by a number of poor performing FHA lenders and reached out to the HUD OIG for assistance. Our office served subpoenas to the corporate offices of 15 mortgage companies in 11 states across the country demanding documents and data related to failed loans which resulted in claims paid out by the FHA fund. We identified these direct endorsement companies from an analysis of loan data focusing on companies with a significant number of claims, a certain loan underwriting volume, a high ratio of defaults and claims compared to the national average, and claims that occurred earlier in the life of the mortgage. These may be key indicators of problems at the origination or underwriting stages. The firms were not selected for indications of wrongdoing on their part but we will aggressively pursue indicators of fraud if they should be uncovered during the analysis. We are a principal member of the President's Financial Fraud Enforcement Task Force and this initiative reflects our commitment to seek information on red flags that may arise from data analysis.

While we are still in the data recovery and analysis phase, and cannot discuss at this time the initial results of our review, we do believe that this initiative will continue. We will carry out our line of inquiry until we have conclusive results to provide to the FHA, to the Congress and to the American taxpayer. It is important to know for the long-term viability of the FHA program whether these skewed high claims and default rates are a result of a weak economy or if companies are ignoring, or even purposefully violating, FHA regulations. We want to send a very distinct message to the industry that as the mortgage landscape has shifted, we are watching very carefully, and that we are poised to take action against bad performers. The American taxpayer demands, especially after the lessons of the subprime collapse, that oversight and monitoring must be rigorously implemented. While we may disagree from time to time with some of the actions the FHA has taken, we both share a common resolve to preserve homeownership at the same time as protecting the American taxpayer from further economic instability.

In an audit on Single Family insurance claims, we found that the Department received and paid claims on loans for which the lender did not show the borrower was able to make the required monthly payments, made the minimum investment in the property, and was creditworthy. It paid the claims and did not review the loan files for compliance with requirements, fraud, and/or misrepresentations. Our initial review under Operation Watchdog reinforces the concerns we found in this claims audit. The Department should review claims for eligibility and, if feasible, independently determine that loans comply with program requirements and seek, from lenders, recovery or adequate support for final costs associated with those claims.

Loan Binder Retention: One issue that has arisen in our reviews of these poor performing lenders is the ramifications of the prior administration’s policy to allow lenders to maintain original records. Through the issuance of a Mortgage Letter in 2005, the FHA enabled certain direct endorsement lenders to endorse FHA loans without a pre-endorsement review and generally relieved those lenders from the responsibility of submitting loan origination case binders to the FHA. The Federal Bureau of Investigation (FBI) and the HUD OIG, vigorously opposed the FHA's directive (as did HUD's own General Counsel at the time) to allow lenders the ability to retain documents. As a law enforcement and auditing agency, we were concerned that such a relaxation of control would hinder our ability to gather information for evidence if documents were tampered with or destroyed. Further, the guidance allowed lenders to maintain the files for only two years after closure. Statutes of limitations run five years in criminal fraud and generally six to ten years in civil fraud matters.

Unfortunately, our fears expressed then in testimony and in a letter-writing campaign are indeed coming to fruition today. As we proceed with Operation Watchdog, we have had difficulty obtaining files from a number of these lenders including encountering instances of missing case files despite OIG subpoena demands. We strongly recommend that the FHA again revisit this directive to ensure information critical to the loan origination and underwriting process is available for detection of issues and/or potentially fraudulent activity. In a time when the American public demands our mortgage industry is free of waste, fraud and abuse, such a policy change is essential.

FHA Financial Condition

The results of the latest actuarial study produced last fall 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 the FHA's Fund to cover losses on the mortgages it insures is 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 the year before. By September 30, 2009 the reserve level dropped below the statutorily mandated 2percent requirement to 0.53 percent. The Fund's economic value was $3.64 billion compared to the $685 billion of outstanding insurance in force.

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. We testified last year that 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. We stated to the FHA during our audit of its financial statement that the model embraced by the FHA should include the study of past and current delinquencies and the ultimate resolution as to cures or claims. The current model is designed for long term claim projections and is based on historical claims paid experience. Therefore, the model does not reflect recent delinquency development and lacks the corresponding adjustment to the claims paid. We recommended that the FHA expand its financial cash flow model validation to include seriously delinquent aged loans data, case level historical recovery data, and other leading indicators; and to track reasons for default and determine whether other economic indicators, such as unemployment claims, may be useful to support near term estimates for claim payments.

An assessment of the first quarter of FY 2010 shows some trends that merit examination. With FHA's greatly increased Single-Family insured volume (a 24 percent change from the prior year and currently at more than three-fourths of a trillion dollars in insurance) comes an increasing default and claims paid rate. Add to this an increasing inventory of real estate owned properties that are managed by the FHA -- with a falling recovery rate that has FHA now only recovering slightly more than 40 cents on the dollar and a "days in inventory" average of close to 200 days -- and the picture becomes more disquieting. A significant problem facing the 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 the FHA to resell its REO properties.

Approximately 8.8 percent of FHA loans are currently in default (i.e., more than 90 days non-payment status, foreclosure or bankruptcy), an increase from the prior fiscal year to date. 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. Claim rates have also increased and though numerically still quite small, it must be noted that many of the new defaults are still in the pipeline. We may see increasing claim rates on the horizon. The Secretary and the Commissioner hope to stave off the consequences of this trend with new approaches to business, but the congressional and executive branch budget offices' disagree with the impact of these approaches.

In our estimation, this only reinforces the importance for FHA-approved lenders to maintain solid underwriting standards and quality control processes in order for the FHA to withstand severe adverse economic conditions. Another extensive problem confronting the 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 though there has been increased funding and new plans formulated. I know in my conversations with congressional staff that they are frustrated with the amount of resources expended and the pace with which such replacement plans have proceeded over the years.

Increased Risks to FHA:

Mortgage Fraud: Last year during testimony before this Subcommittee, I highlighted a variety of traditional mortgage fraud schemes impacting both the FHA and the conventional loan market including schemes in areas such as appraisal fraud and loan origination fraud, and identity theft as well as new forms of fraud such as rescue or foreclosure fraud (to include equity skimming and lease/buy-back plans), bankruptcy fraud, and Home Equity Conversion Mortgage (reverse mortgage) fraud (to include schemes involving flipping, annuity sales, unauthorized recipients, and onerous fee payments/consumer fraud). As the Department of Justice recently testified, all types of mortgage fraud are on the rise and we are working closely with other agencies in the President's Financial Fraud Enforcement Task Force and as part of the National Mortgage Fraud Team. We currently have over 2,290 case subjects involving Single Family investigations. We have also recently created a more robust civil fraud enforcement initiative to assist the Department of Justice in enhancing civil mortgage anti-fraud prosecutions. For example, we recently assisted the Department of Justice in filing a complaint against Capmark Finance Inc, a large originator of HUD-insured loans, for making false statements in connection with applications used to acquire two nursing home facilities (a discussion of nursing home issues appears later in this testimony). The following represents a sample of a few of the criminal fraud cases we have recently pursued:

- In Operation Mad House, we conducted an undercover investigation to deal with the problem of escalating mortgage fraud in the Chicago area that had consistently placed it as one of the top five geographic areas for fraud. We received allegations that a number of mortgage operatives were involved in loan origination fraud including the creation of fictitious bank statements, false employment and inflated appraisals and we targeted an organized group of real estate industry professionals at all levels. We tracked the inflated appraisal and phony origination as well as the closing proceeds and how it was distributed. This investigation resulted in 22 individuals in 9 separate indictments being charged with multiple counts of fraud and a spin off whereby 4 new subjects were indicted late last year. All told, 26 principals in the mortgage industry including attorneys, brokers, loan officers, loan processors, appraisers, recruiters, and accountants have been charged.

- Earlier this month in Atlanta, three members of a reverse mortgage fraud ring were indicted by a federal grand jury for altering real estate records, using fake documents, and posing as realtors in an abuse that took money away from qualified seniors. The defendants in this case faked required down payments by senior citizens to establish the equity needed in the home to qualify for the reverse mortgage. They did this by using bogus gift letters in amounts between $50,000 and $105,000 and using fake HUD-1 Settlement Statements reflecting the sale of non-existent assets closed by fictitious law firms to show the source of the required down payments. All the down payments were actually supplied by the defendants, not the senior citizens, to be returned to the defendants upon the reverse loan closings along with profits far in excess of the true sales prices of the properties. Such payments were disguised as seller proceeds or lien payoffs and all the mortgages contained fraudulently inflated appraisals.

- In another reverse mortgage case, on April 13, 2010, in Kansas City, Missouri, the Jackson County Prosecutor charged an individual with financial exploitation of an elderly/disabled person and forgery related to a fraudulent HECM (home equity mortgage conversion) loan. Our investigation revealed that the defendant allegedly obtained a quit claim deed on a Kansas City property belonging to an elderly man suffering from Alzheimer's disease and subsequently took out a fraudulent reverse mortgage in the victim's name. As a result of the scheme, the defendant deposited, by means of a forged Power of Attorney, reverse mortgage proceeds into a personal bank account as well as obtained a loan against the victim's life insurance policy.

- In February of this year, the former president of a mortgage company was sentenced in federal court in California to 156 months in jail, five years probation and ordered to pay almost $30 million in restitution to victims for a fraudulent loan origination scheme that knowingly caused loan applications containing fraudulent documents to be submitted to various lenders for FHA insurance so that unqualified mortgagors would appear qualified. His actions caused over 900 fraudulent loans to be FHA insured and subsequently default resulting in a substantial loss to the program.

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. As of the end of calendar year 2009, HUD had 2,327 projects with an outstanding principal balance of $14.6 billion. This represents close to a 36% increase in projects receiving initial endorsements from the previous year. As we noted in last year's testimony, 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 involved, the OIG has been recommending for years in numerous audits and investigations that the regulatory agreement needs to be changed. This status has not changed since approximately the fall of 2006. It is our hope that this can be done expeditiously.

Appraiser Oversight: Our review of the FHA appraiser roster identified 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 $800 billion representing over 6 million in FHA insured mortgages. Inflated appraisals correlate to 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, and appraiser fraud a significant problem highlighted in national studies, 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 study indicated that 90 percent 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. As can be deduced from the many cases and problematic issues discussed in this testimony, inflated appraisals often are at the heart of the scheme or of the questionable arrangement.

Late Payment Endorsement Requirements Changed: Last year, we testified on results from a number of other key audits that have noted significant lender underwriting deficiencies, inadequate quality controls, and other operational irregularities. We spoke to an audit in which we analyzed the impact of FHA late endorsement policy changes affecting FHA insured loans. Unfortunately, this still remains an issue and bears repeating. 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 7 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, we found that the default rate for loans submitted late had increased and was 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."

In 2006, we 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 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. 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.

Capturing Key Information in, and Upgrading, Data Systems: Another major concern, touched on previously in testimony, is the integration and upgrading of FHA legacy systems which bears repeating since our original premise has not been acted on. While there has been much discussion of an overall plan, and what particular types of systems are needed to go forward, 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, loan processor, and real estate agent.

The loan officer, for example, is central to the origination of the loan where due diligence should be exercised on the application material (i.e., credit scores, appraisal information, etc.). It would be useful to record the person's name and corresponding identifying information (i.e., license) in the same system the FHA uses to track underwriter and appraiser details. This will allow the FHA and OIG to key in on a vital part of the loan process – origination -- where 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. It would also be valuable to the FHA in strengthening its risk management and monitoring efforts.

Further, it could be beneficial for the FHA to participate more significantly in a unified lender oversight consortium with Fannie Mae, Freddie Mac, the Federal Deposit Insurance Corporation (FDIC), 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.

Earlier in the testimony, we described the TBW case and the weaknesses that it exposed in the FHA and the Ginnie Mae programs. As we are discussing the need for federal entities to come together in a more unified manner, we would also like to highlight an issue that came to forefront in this case. Ginnie Mae mortgage-backed securities (MBS) 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.

The FDIC temporarily froze the Ginnie Mae custodial bank accounts at Colonial Bank as well as the bank's mortgage payment lock box account. As a result, Ginnie Mae was forced to make an approximately $1 billion pass-through payment (principal and interest) to investors. There needs to be better coordination between the FDIC and other federal government agencies so that losses absorbed because of its action can be mitigated by more cooperative and forward-thinking behavior. We are also very concerned with the extent that future bank failures and bankruptcies could have on the Ginnie Mae program. The FDIC stated in a recent report that over 200 banks are predicted to fail this coming year.

The other disconcerting aspect of the TBW case involves the fact that Fannie Mae became aware of some unsettling practices at TBW, made it replace some loans and then stopped doing business with it. TBW then sold their servicing rights to another company and started doing business with Freddie Mac. Then, down the line, Ginnie Mae accepted pools from TBW. It appears that Fannie Mae's only interest was self-interest. A number of years ago, I testified before the House of Representatives regarding a case called First Beneficial in which Fannie Mae did not tell other entities of its discoveries at First Beneficial and then, by its silence and inaction, caused losses to the Ginnie Mae program. There needs to be mandated requirement of notification and penalty for failure to notify or we will continue to see instances of fraud cases being perpetrated on unknowing securitizers.

Continuing Concerns

Though there have been incremental increases in funding to the FHA for a variety of staffing and system needs, including a planned increase of over 100 FTEs from FY 2010 to FY 2011, we believe there remains a need for either more, or a proper placement of, resources to the FHA in light of the dramatic percentage of increased loan volume and of its increased relevance to the eventual stabilization of the conventional mortgage marketplace. We would like to see more personnel dedicated to the Homeownership Centers, which are responsible for monitoring loan origination and servicing practices, setting underwriting standards, and overseeing the disposition of HUD-owned properties, as well as to headquarters systems and technology until the IT infrastructure can be put in place in order to manage the program changes, and away from such activities as marketing since FHA has already proclaimed it wants to retreat from such a prominent place in the marketplace.

We still remain concerned that increases in demand to the FHA program are having collateral implications for the integrity of Ginnie Mae. Like FHA, Ginnie Mae has seen an augmentation in its market share. For example, in December 2009, its Single Family issuances totaled nearly $40 billion and it had a remaining principal balance of over $880 billion. By comparison, its balance in December of 2007 was exactly half at slightly over $440 billion. It too has stretched and limited resources to adequately address this increase.

Conclusion

Mortgage industry behavior was a precipitating factor in the present economic turmoil. As the Department has written about in its assessment of the foreclosure crisis, industry participants encouraged borrowers to take riskier loans with a high risk of default due to the high profits associated with originating the loans and packaging them for sale to investors. These lenders had little or no risk in the loan. There were many factors that made it possible for the mortgage market to make so many miscalculations and missteps. A primary factor was development during this period of the growth of the asset-backed securities market, which shifted the primary source of finance from federally regulated institutions to mortgage banking institutions that acquired funds through the broader capital markets and were subject to much less regulatory oversight.

Clearly the regulatory structure was not changing rapidly enough to keep with the pace of growth. Fraud may have had a significant contribution and analysis shows that there was a lack of adequate underwriting controls by lenders to oversee brokers' activities. The general regulatory structure did not work to provide adequate oversight to oversee the origination and financing of mortgages. The consequences were high risk lending and a resulting surge in delinquency and default. The lessons of the conventional side of the industry should not be lost on that of the FHA and Ginnie Mae programs as they too are now experiencing increasing delinquencies, defaults and claims. And it should not be lost on those tasked with rectifying the vulnerabilities that clearly came to the foreground regarding the lapse in oversight of the Fannie Mae and Freddie Mac government sponsored enterprises.

The conventional mortgage market is going back to the basics. It is embracing full underwriting standards including accurate verifications of income, employment and appraisal; it is demanding adequate cash down payments from borrower's own funds; and it is seeking rational debt-to-income ratios. Observations of current historic contagions of risk suggest that, in the marketplace today, yesterday's lower 600's FICO score is now today's higher 600's FICO score and that FHA's floor may be set too low. Nevertheless, this has to be weighed against the FHA's traditional mandate to assist homeowners that are low to moderate income and who may have poorer FICO scores. It also suggests that even high FICO borrowers with significantly distressed properties still default because of the rational choice to prevent years of principal payments just to break even. This makes it all the more important to have an active risk management department to monitor and rapidly develop policies as the traditional "black-boxes" adapt to the "new."

Finally, we remain concerned that, 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 have not seen enough progress or initiative to try to overcome the vulnerability that lapses in coordination among federal entities creates. Of one thing, however, we are sure -- those intent on unscrupulous behavior know full well how to exploit the weaknesses in the system and to profit from such disorder. We do very much look forward to the implementation of many of the Secretary's 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.

As Chairman Murray has stated, stabilizing and improving the housing market is critical to the nation's economic recovery but FHA's participation must be done in a way that it can effectively manage the loans that were made during the height of the housing boom so that it can provide a much-needed boost of liquidity to the market. 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.