STATEMENT OF
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SUBCOMMITTEE ON INVESTIGATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
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Madame Chairman and other members of the Subcommittee, it is my pleasure to testify before you today on the subject of property flipping in connection with FHA-insured mortgage transactions. Accompanying me today are Kathryn Kuhl-Inclan, Assistant Inspector General for Audit, and Philip A. Kesaris, Assistant Inspector General for Investigation.

The Department continues to point out that the FHA insurance fund is financially the healthiest it has been in many years. FHA continues to exceed its capital reserve requirements and FHA loan origination activity is growing. Much of this financial health is due to a robust economy, recent FHA actions to correct the problems associated with Adjustable Rate Mortgages, and a high mortgage insurance premium structure. 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. Most FHA loans include a 2.25% up front premium as well as an annual premium of ½% of the outstanding mortgage principal balance.

We are not here to debate the financial viability of the FHA Insurance Fund. That viability is based on an actuarial study supported by numerous assumptions about future economic performance. Those are economic factors we have little control over. We are instead here to discuss what we consider massive fraud in FHA loan origination activities. Just because the FHA fund is profitable is no reason to tolerate program fraud. The fraud we are finding harms 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 are seeing in our audits and investigations. It is important to keep in mind that a troubled loan today may take several years before it results in an FHA claim.

The Flipping Problem

Now let me turn to the phenomenon of property flipping. Buying a home at a low price and then reselling it at an inflated price within a short time frame, often after making only cosmetic improvements to the property, is in and of itself not illegal. It’s no different than you and I making a few dollars on the stock market by buying low and selling high. In playing the market, we take a risk and sometimes it pays off with profits. But, we know there are laws to ensure that our stock profits are the result of arms length transactions and that our gains are not based on insider trading. 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 a 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--i.e., 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 becomes the valuation measure for the next property and so on and so on. Before long, these transactions have a devastating effect on neighborhoods. I'm certain that for every property flip that results in a defaulted FHA loan, there are many others that go undetected as homeowners continue making payments on inflated mortgages.

Our audits and investigations have indicated that 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 the dream of home ownership turns into a nightmare as the property begins to need major repairs and the owner discovers that the property's real value is only a fraction of its original purchase price.

Let me provide you with a few examples of recent OIG criminal investigations involving property flipping:

- Last week 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.

- In December 1999, 39 individuals were indicted in Los Angeles, California, for engaging in a $110 million dollar fraudulent loan scheme. To date, almost all of these individuals have pled guilty to wire fraud, money laundering, and HUD fraud charges. This case began with the identification of an individual who was a forger of loan documents who had kept diligent records over a 7-year period of creating false documents for inclusion in loan packages submitted to FHA for insurance. The investigation quickly uncovered a layer of investors and others involved in the real estate industry who were operating throughout the Los Angeles Basin using the forged documents in flipping schemes. Multiple properties were bought and quickly resold at inflated prices based on fraudulent appraisal values. Large loans were made based on the inflated appraisals, and sellers and those participating in the scam lined their pockets with the extra cash. At the press conference announcing the indictments, the United States Attorney said that "this type of fraud takes money from parents in need, those who dream of providing a house for their children, and puts it in the pockets of people who have been licensed as professionals but who really are just criminals–and greedy ones at that."

- In another case in Los Angeles, a mortgage broker pled guilty to conspiracy and loan fraud by obtaining false verifications of employment, income, and gift letters on behalf of alleged mortgagors for the purpose of obtaining FHA insured loans. He used strawbuyers to act as purchasers of the properties which were insured for over $1 million.

- 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 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.

- In just one loan origination fraud investigation that is currently ongoing, we have identified over 1,200 FHA insured loans totaling over $160 million dollars; 25% of the loans, over $40 million dollars, have already resulted in defaults and many have resulted in claims to FHA. Common to all 1,200 of these loans: a small group of individuals who prepared fraudulent documents and provided false verifications of employment that were used in the origination of each loan. A total of approximately 100 individuals employed in various segments of the real estate and lending industry requested and paid for the fraudulent documents.

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. It is our belief that had appropriate controls been in place, these fraudulent activities could have been more quickly identified and the losses minimized.

When we become aware of a fraudulent transaction, we attempt to determine 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 which allow the fraud to occur. The desire of each party (e.g., the lender, broker, appraiser, real estate agent, seller, etc.) to make its fee and/or profit from the financial transaction, the liberalization of FHA underwriting standards, the severe reductions in HUD monitoring staff, and the lack of clearly defined responsibilities brought about by major organizational changes in HUD all combine to increase the vulnerability for fraud.

HUD has undertaken major structural and organizational changes in single family operations over the last five years. These include the consolidation of field operations into four Homeownership Centers, significant staffing cuts in headquarters and field operations, and the contracting out of major portions of the workload. During this period of change, the single family program has been particularly vulnerable to fraud, waste and abuse. Fortunately, a high mortgage insurance premium structure and a very strong economy have enabled FHA to more than meet its capital reserve requirements. However, a future economic downturn could seriously affect the financial well being of FHA's mortgage insurance fund.

In the last year, through our audits, investigations and Housing Fraud Initiative activities, we have examined nearly every aspect of the single family program. This work clearly demonstrates (1) a high incidence of fraud, waste and abuse in FHA's single family operations, and (2) a clear need for HUD to tighten controls over this multi-billion dollar insurance operation.

Our audit and investigative work has disclosed that HUD's current procedures for monitoring lenders, overseeing contractors and supervising HUD staff activities are less than effective. This lack of oversight and accountability can result in criminal activity going undetected. Let me illustrate this with a recent example. Last year, a HUD employee in the Santa Ana Homeownership Center was convicted for accepting bribes and tax evasion. The employee conspired with a real estate agent to carry out a systematic scheme of selling HUD-owned properties at prices far below HUD's listed price. The FHA Insurance Fund lost several million dollars as a result of this scheme. We conducted a review to determine what if any controls would have prevented this occurrence. We found that the controls were there but were not being followed. The Chief Property Officer (CPO) was required to review and sign off on property discounts. This was not being done. We recommended disciplinary action be taken against the CPO for failing to perform his supervisory duties. In response to our recommendation the Department stated that "the CPO at the time would not have been able to perform all the supervisory and monitoring duties prescribed in the Handbook and should not be subject to any administrative actions." It seems that this major breach of internal controls is being dismissed for a lack of staff brought about by recent HUD reforms.

HUD's mortgage insurance risk depends almost exclusively on the reliability of work performed by its direct endorsement (DE) lenders. DE lenders 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. Our audit of HUD's single family loan processes found that HUD monitoring was not focused on lender and appraiser high risk indicators. Rather, HUD's focus was on meeting numerical review goals as set out in its Business and Operating Plan.

Post endorsement technical reviews

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 contract costs ranging from $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. The contractor found no significant problems with these loans, even though the loan files showed obvious fraud indicators. 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.

Even when significant technical review problems were noted, HUD implemented few if any corrective actions. The post endorsement technical review process can identify questionable employment, fraudulent gift letters or other questionable origination documentation which are commonly found in flipped sales transactions.

Post endorsement field reviews of appraisals

Another critical control feature 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 and each lender's performance and follow-up when problems are noted. We found that these controls were not being followed.

Most of the appraisal field review work was performed by contractors. In several HUD field offices, we found there were no contracts in place and reviews were not being performed. We found several other offices where there was an insufficient number of field reviews being performed. Even when appraisal problems were found during field reviews, HUD was not using the results to take action against appraisers. Branch Chiefs at three HOCs commented that they did not have enough staff to monitor appraisers or to sanction poor performers. As a result, HUD lacks assurance about the quality of appraisals supporting loans processed and approved by lenders. The field review process for appraisals is one of the easiest methods of identifying flip sales. A good quality control check will look at the reasonableness of comparable properties used for valuation purposes.

Quality Assurance Reviews

A third important control over direct endorsement lender activity is the on-site monitoring review. These reviews, which are conducted by the Homeownership Centers' Quality Assurance Divisions, are intended to identify and correct poor origination practices. After completion, the Divisions communicate the review results to lenders and request written responses. Lenders are asked to explain the problems noted, list actions taken to prevent future problems, and/or agree to indemnify HUD for possible losses associated with improperly originated loans. While the Quality Assurance Divisions should focus on lenders with high defaults and foreclosures, many low risk lenders were reviewed in order to meet review goals. Even when the Quality Assurance Divisions identified deficiencies during on-site reviews, they were not following up when the mortgagees did not respond to the findings and recommendations. A quality control check of title information in lender files can easily identify evidence of flip sales.

HUD's Response to the Problem

To address property flipping and other lending abuses, FHA has developed a Fraud Prevention Plan. The Plan identifies a series of new initiatives to address predatory practices targeted at FHA and its borrowers, including inflated appraisals, fraudulent underwriting, property flipping and other lending abuses. FHA's reforms, to protect homeowners from predatory lending, focus on two main areas: (1) providing relief to those FHA borrowers already in distress, especially those who have been victimized by abusive lending practices; and, (2) strengthening FHA endorsement and fraud detection procedures to prevent predatory practices from occurring in the first place. The new reforms build on existing FHA efforts to streamline operations and eliminate abusive practices including the Homebuyer Protection Plan and the Credit Watch Program.

Virtually none of the Fraud Protection Plan measures were in place when we were doing the audits and investigations discussed in this testimony. However, we have briefly looked at the Fraud Protection Plan and we have several concerns. First, who will carry out this effort? The implementation of the plan will be staff intensive. It seems clear from our prior audit work that the Homeownership Centers are not adequately staffed to deal with the many new requirements set out in the plan such as victim relief, loan restructuring and credit repair. This focused effort on "Hot Zones" requires more people. If HUD HOC staff are used, then, something else won't get done. A review of staffing allocations last year by NAPA of the Denver HOC found that office was 1/3 short of staff. Consequently, assigning additional work to the HOCs without people is not the answer. It is more likely that this plan will result in additional work for contractors. Historically, we have seen that HUD does not do a good job of overseeing these contractors.

Secondly, while attempting to accomplish all that is set out in the plan is laudatory--i.e., curing the problems of predatory lending--in reality it may be impractical. Each flipped deal will require an intensive investigative effort. Trying to determine the circumstances and reliability of an appraisal conducted six months or a year ago will be extremely complex. Determining whether or not the buyer received some sort of remuneration from the seller to close the deal will be difficult to assess. Overall, it will require an intensive investigative effort. Also, since the plan will look into all examples of flipping, whether or not the borrower is in default, it will also be an extensive investigative effort.

Our third concern is how will the cost of this plan be paid. Writing down mortgages to the true value of the property will require someone to pay the costs. Will those costs be born by HUD? What is the estimated cost to the FHA fund? Will this result in a litigious effort between lenders, appraisers and HUD? In summary, the FHA Fraud Prevention Plan appears to be only a sketch of proposed actions; we would need some detail to be able to evaluate its potential effectiveness.

Additionally, while the Homebuyer Protection Plan and the Credit Watch program are noted as two new measures to strengthen the FHA program, they are both in their formative stages. We see these as positive measures to assist in identifying problem loans and lenders. The Homebuyer Protection Plan will help in assuring the accuracy of appraisals as well as identifying problem appraisers. But, it is only within the last few weeks that the Department has begun identifying problem appraisers through this process. Also, the Credit Watch Program is designed to withdraw the approval of lenders with the most egregious default records. But the first Credit Watch actions taken by the Department are being legally challenged.

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HUD's announcement of these various initiatives is an important sign that the Department has recognized the seriousness of the fraud pervading its single family mortgage insurance program. However, these initiatives may take several years before they show any substaintial impact on HUD foreclosure statistics. While we applaud the objectives of the initiatives, we note that they are largely in the formative stage, and they rely on a willingness to take enforcement actions that has been historically lacking in the single family mortgage insurance program. Further, for the most part, these initiatives are over and above the day to day responsibilities of HUD's single family staff for preventing fraud and abuse in the first place.

Let's focus on getting the job done right in the first place. Recognizing that HUD's single family staff have been through downsizing, reorganization, and heightened workload expectations, let's 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 pretty boring endeavor. But that's how real work gets done.

Madame Chairman, I appreciate the concern the Subcommittee has shown about fraud in the single family mortgage insurance program, and the devastating effects it has on individuals and communities throughout this country. I thank you for the opportunity to present the views of the Office of Inspector General at this hearing, and I pledge our full support for your efforts to strengthen the single family mortgage insurance program.