STATEMENT OF
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HOUSE COMMITTEE ON THE BUDGET

“WASTE, FRAUD, AND ABUSE IN MANDATORY SPENDING PROGRAMS”

THE UNITED STATES HOUSE OF REPRESENTATIVES
JULY 9, 2003

Thank you for inviting me to submit a statement for the record on waste, fraud, and abuse in mandatory spending programs within the Department of Housing and Urban Development (HUD). For budgetary purposes, our insurance programs meet the definition of mandatory programs. Consequently, my remarks will only focus on our audit and investigative efforts involving the Department's insurance and guarantee programs, The Federal Housing Administration (FHA) and the Government National Mortgage Association, known as Ginnie Mae. While these Government Sponsored Enterprises are considered mandatory programs, the monetary savings identified through our audits or investigations would generally not be returned to the U.S. Treasury. For example, the FHA insurance programs are self-sustaining. Income is generated through borrowers' mortgage insurance premiums and the costs for foreclosure losses are paid by the insurance fund. Mortgage insurance premiums are adjusted up or down to cover program needs. If there are excess premium revenues, the Assistant Secretary may authorize the payment of premium refunds.

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Last month, we provided testimony for the House Committee on Financial Services on areas of potential savings from our discretionary programs. We identified several older programs with remaining obligated funds from expired contracts (i.e., HUD's Section 8 Program which provides rental assistance to low-income households). We recommended that these obligations be recaptured and used to offset future budgetary needs. In response to our findings, the Department has taken action to offset fiscal year 2004 funding by $1.7 billion.

Program Background. FHA was created as a U.S. Government Corporation within HUD and administers active insurance programs designed to make mortgage financing available to the home-buying public. FHA insures private lenders against loss on mortgages that finance single-family homes, multifamily projects, health care facilities' property improvements and manufactured loans. Ginnie Mae, through its Mortgage-Backed Securities Program, facilitates the financing of residential mortgages by guaranteeing the timely payment of principal and interest to investors. Ginnie Mae issuers pool FHA, VA and Farmers Home mortgages into mortgage-backed securities. The Ginnie Mae guarantee gives lenders access to the capital markets to originate new loans.

FHA insures more than a million loans each year. FHA's outstanding insurance portfolio exceeds $600 billion. Last year, Ginnie Mae reached the $2 trillion mark in mortgage-backed securities issued since 1970. The outstanding portfolio of these securities now exceeds $587 billion. FHA and Ginnie Mae, from a financial standpoint, are both fiscally sound organizations. FHA mortgage insurance premiums more than cover any losses incurred through the foreclosure and note sales processes. The FHA insurance fund is actuarially sound and it more than exceeds the 2% capital ratio requirement set by the Congress. Ginnie Mae fees charged to issuers currently earn Ginnie Mae between $700 and $800 million annually.

The Magnitude of the Problem. You requested an estimate of the magnitude of waste, fraud and abuse in these programs. As you can see from the balance of my testimony, there are so many players in our programs that making such an estimate would be extremely difficult. HUD relies on thousands of approved FHA direct endorsement lenders for underwriting. These lenders accept applications, verify borrower income/ assets / liabilities, and determine appraised property values. Any of these many processes in the origination of an FHA loan can be compromised. Much of our mortgage and lender targeting for OIG review is based on the small percentage of loans that may be in default or foreclosure at any time.

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With more than a million FHA loans insured each year, the slightest percentage of fraud can equate to high-risk loans valued at hundreds of millions in dollars. HUD uses a detailed lender default monitoring system to identify lenders with a high incidence of defaulted loans. FHA's Quality Assurance Division and our office both use this default information to identify lenders for review. An early loan default is generally a good indicator of underwriting irregularities. However, not all failed loans are fraudulent--job loss, health issues, divorce, etc., may be the reason for default. A significant part of our audit and investigative resources are committed to FHA lender and Ginnie Mae issuer reviews. Last year, we opened numerous investigations on individuals potentially involved in FHA insurance fraud and our workload continues to drastically increase.

Single-Family Mortgage Fraud continues to be an investigative priority for the OIG. Our investigations of perpetrators of fraud include: title companies, loan officers, mortgage companies and brokers, real estate agents, closing attorneys and appraisers. These perpetrators, through a variety of schemes, submit fraudulent loan applications, appraisals, and other falsified loan documents and/or utilize straw-buyers, and other conspirators, to effect the fraud.

Our Semiannual Report to the Congress for the period ending September 30, 2002 reflected investigative recoveries of $59 million. During the same period approximately 60% of our cases and 90% of our investigative recoveries were attributable to Single-Family mortgage fraud cases. During the first six months of this fiscal year, investigative recoveries are approximately $65 million, a figure that already exceeds our recoveries for all of fiscal year 2002.

Recent statistical information gathered from our 10 investigation regional offices shows that investigative efforts expended on these Single-Family cases involve approximately 1400 subjects who have originated more than $1 billion in loans affecting nearly 36,000 FHA-insured properties. These investigations are worked in coordination with 148 Assistant United States Attorneys.

A recent focus of our audit and investigative work has been on Single-Family property flipping. In certain parts of the country, especially in urban areas, investors have been purchasing distressed properties and reselling them to an FHA-insured purchaser at an inflated value. The purchase and resale was often done on the same day. In many cases, there was collusion between sellers, lenders and appraisers to inflate values. In our OIG reviews, we found a wide disparity between the original purchase price and the resale price of the property. The concentration of flipped properties in certain neighborhoods resulted in one inflated property value being used as the comparable (i.e. setting the value for another property). We have found, in particular, a concentration of problems in Los Angeles, New York City, Ft. Lauderdale and Baltimore. These involved hundreds of properties and millions of dollars in losses to the FHA insurance fund. An example of one of our flipping investigation involved Schmidbauer Realty, Inc. of Baltimore, Maryland.

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The OIG identified a series of real estate “flip” transactions through a company owned by William Otto Schmidbauer. Schmidbauer bought and then resold numerous Single-Family properties at prices well above their market value. He used straw-buyers to complete the transactions and would use pre-selected lenders, loan officers and appraisers to facilitate the loans. The 58 real estate transactions identified to date involved approximately more than $5 million in fraudulent FHA loans. Eleven straw purchasers and one loan officer have entered guilty pleas in the District of Maryland.

Early this year, working with HUD program staff, a property-flipping rule was put in place to stop immediate property sales or flips. By establishing a ninety-day waiting period between FHA sales, investors cannot quickly resell properties as they did in the past. We anticipate this rule will deter a major part of fraudulent property flipping schemes.

Multifamily Equity Skimming is another major focus of our audit and investigative endeavors in FHA programs. Equity skimming is the illegal use of rents, assets, proceeds, income or other funds derived from an FHA-insured multifamily property for purposes other than to meet actual or necessary expenses. When owners do not pay their mortgages, the living conditions in the developments can deteriorate because the funds intended to maintain the individual units and common areas are diverted for unauthorized uses.

A recent example of equity skimming involved a housing development in the Bronx, New York. The owner of the project was found guilty of equity skimming and ordered to pay restitution to HUD in the amount of $894,000. The owner took cash from the project for fraudulent expenses and stopped making mortgage payments. In another case, the project manager of four projects in West Virginia was found guilty of submitting false invoices for maintenance work not performed. As a result, the physical condition of the projects deteriorated. This case involved more than $800,000 of false invoices. The project manager was sentenced to two years in jail, three years probation and ordered to pay $250,000 in restitution.

HUD requires that insured projects receive a financial audit each year. In the course of these reviews, the auditors identify the source and use of funds at the project. These reports may provide information that funds are being removed from projects in a non-surplus cash position and thereby assist HUD-OIG investigators and auditors and the Department in its efforts to uncover such activity.

Ginnie Mae Issuers are responsible for pooling eligible mortgages into mortgage-backed securities and passing mortgage payments through to investors each month. Another recent OIG investigation involved First

Beneficial Mortgage Corporation (FBMC) of North Carolina who was an approved FHA direct endorsement lender as well as an approved Ginnie Mae issuer. At the time the fraud was detected, this issuer had a Ginnie Mae mortgage-backed security portfolio worth $45 million. FMBC saw a window of opportunity to originate fraudulent FHA mortgages and then pool them into mortgage-backed securities. By using the investor proceeds from the sale of securities, the issuer was able to continue a "pyramid" scheme by appearing to pass through mortgage proceeds. Over 100 of the pooled mortgages in 11 Ginnie Mae pools were, in fact, fraudulent. FMBC systematically recruited straw-buyers to sign fraudulent and fictitious mortgage notes for vacant parcels of land. FBMC would then submit these false notes to their registered document custodian as backing for their securities as required by Ginnie Mae.

FBMC was permitted to sell millions of dollars of Ginnie Mae securities without verification through, or by, FHA that these mortgages were appropriately insured. FBMC was continuing to issue pools using false documents. FHA and Ginnie Mae communications could have detected the fraud earlier. A simple verification by Ginnie Mae that the FHA pooled loans were, in fact, insured would have raised a red flag. Ginnie Mae has since started a process of verifying whether Ginnie Mae pooled mortgages are FHA insured. This control should help detect improper pools within a few weeks of their origination.

Corrective Actions. As we identify possible systemic weaknesses in HUD's operations through our audits, we make recommendations that, in our opinion, will best correct the problem. These recommendations will assist in the correction of many internal control weaknesses by establishing sound checks and balances through handbook or regulatory changes. In addition to administrative recommendations, a legislative remedy may, in our estimation, be required in some instances. Over the years, we have submitted legislative proposals to the Congress in an effort to reform wasteful or ineffective features in HUD programs, increase accountability in the award of financial assistance, and improve program enforcement.

Our last submission a number of years ago included close to 40 proposals. Several of these proposals involved FHA activities. For example, we proposed the elimination of the Title 1 program under Section 2 of the Housing Act. This program provides insured loans for home improvements and for the purchase of mobile homes. We based our proposal on the small number of individuals served, the inability of HUD to effectively monitor this program and the availability of private sector financing. Another proposal was to eliminate investor participation in the Section 203(k) rehabilitation mortgage insurance program. We based our proposal on our findings in a comprehensive review of the 203(k) program where investors were using the program to obtain unjust enrichment. The Assistant Secretary for Housing voluntarily suspended the program for investors based on these findings. We have also made several other proposals to increase penalties for activities relating to mortgage fraud.

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In closing, our audits and investigations continue to uncover fraud and abuse in HUD's programs. Abuses, such as those discussed above, have a tremendous economic impact on the lives of the citizens these programs are intended to serve. We are continuing to work jointly with Departmental officials to correct the many problems I have discussed. I recently hosted a forum in Philadelphia wherein senior managers from OIG and HUD programs met to discuss waste, fraud and abuse. We characterized this meeting as a "fraud symposium" where the OIG worked together with program staff in collectively addressing prevention and detection of losses in the programs. This collegial effort has been successful and will continue into the future.

I've been the Inspector General at HUD for little more than a year. It has been a very productive time. I have a well-trained and very dedicated staff. Our goal is to ensure that the billions of taxpayers' dollars appropriated by the Congress for HUD programs are used effectively to provide safe, decent, and sanitary housing for millions of Americans. I've tasked my staff and I have challenged program officials to work together to combat waste, fraud and abuse. The structure of HUD programs and the diversity of programs make this a formidable task. But by working in coordination together with program staff and Congressional staff, I think we can take positive steps to make HUD operate in an optimum manner.