STATEMENT OF ROBERT C. GROVES
ASSISTANT INSPECTOR GENERAL FOR INVESTIGATION
OFFICE OF THE INSPECTOR GENERAL
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
Monday, September 10, 2001
BEFORE THE SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES
U. S. HOUSE OF REPRESENTATIVES
HUD 203(k) Rehabilitation Loan Fraud

Chairman Kelly, Mr. Gutierrez and other Subcommittee members, I appreciate the opportunity to appear before you today to discuss the frauds associated with HUD's 203(k) rehabilitation mortgage insurance program in New York City. I will first talk about details of our investigations in Harlem and then about what was happening internally in HUD in terms of program oversight. You will see that this fraud, which will ultimately cost the Department tens of millions of dollars, occurred because of a combination of deception, collusion and lax oversight. Mortgage loan funds intended to improve the Harlem neighborhoods were pilfered by various parties to these transactions. HUD and Harlem will suffer from these losses. In the investigation I will describe for you today there have been 33 arrests and 19 of those individuals have entered guilty pleas.

<u>203(k), the New York Investigations</u>

The 203(k) program allows a borrower to get a single mortgage covering the current purchase price of a property in need of repair as well as the estimated cost to rehabilitate that property. HUD must assure that the total costs (cost of property needing repair plus rehabilitation costs) are reasonable for that market area. The program generally requires the rehabilitation portion of the loan to be escrowed by the lender and drawn down as the work is completed over a six-month rehabilitation period. HUD approved direct endorsement lenders generally perform these tasks for FHA during the underwriting process. Obviously such loans carry a greater risk to HUD because of the inherent uncertainties of rehabilitation work.

We began our investigative work a little more than two years ago. HUD's Quality Assurance Division identified a high level of mortgage activity and a high rate of default for the 203(k) program in New York City. At the same time, we received information from HUD's Office of Fair Housing about not-for-profit organizations complaining about mortgage companies. Also, we found that the District Attorney's Office in Manhattan was investigating potential housing abuses by a not-for-profit organization. The scope and breath of these frauds grew bigger and bigger the closer we looked. One lender, Mortgage Lending of America (MLA), was heavily involved in many of the 203(k) frauds in New York City, particularly Harlem. MLA originated about 270 fraudulent 203(k) loans using 13 not-for-profit organizations. The principal value of these loans was $77.8 million dollars and almost all are in default or foreclosure. The frauds involved a combination of actions to include:

- Inflating the initial "as is" value through one or more property flips
- Rigging appraisals that inflated values
- Underestimating the costs for rehabilitation work
- Drawing escrow funds for rehabilitation work not performed
- Falsifying downpayment documentation
- Falsifying loan origination documents
- Equity skimming- collecting rent while not paying the mortgage

The central scheme was to illegally obtain federally insured 203(k) loans by using not-for-profits as fronts to buy properties at inflated values. Values were further inflated by falsely reporting that certain rehabilitation work would be performed. Hundreds of properties were affected by this scandal. It is tangled webs of criminal activity involving real estate investors, not-for-profit organizations, attorneys, appraisers, and lender employees. As the scandals grew, there seemed to be a "feeding frenzy" among the various players that could profit from the vulnerabilities of the 203(k) program. The conspiracy among these parties made the detection of the frauds difficult. Today I will discuss some of the more prevalent schemes.

Property Flipping In the 203(k) program, the process begins with a property needing repairs. A determination is made as to its current "as is" value. That value is generally determined by the purchase price in the marketplace. In the Harlem cases, we found that properties were being bought by real estate investors and then resold to not-for-profits at inflated prices. Not-for-profit organizations, most of which had never been in the housing business, were paid kickbacks from $5000 to $10,000 to make false statements in the loan origination documents and purchase these properties. Investors working with the not-for-profits arranged to cover all the cost of the transaction including the down payment.

The "flip" sale established the "as is" value for the 203(k) transaction. Investors bought up hundreds of Harlem properties in various stages of disrepair and immediately sold them to not-for-profits at a substantial profit. One not-for-profit purchased 104 properties following this scenario. In some of the Harlem cases, the profit on the flip transaction alone was as high as $165,000. In a matter of a few days or sometimes hours, the investors picked up an immediate profit on the purchase and resale of a property. At times, these properties were little more than an existing building foundation. We estimate that in this scheme the co-conspirators made more than $20 million in profit from the flips.

Inflated values for flipped properties. In calculating the 203(k) mortgage amount, the "as is" value plus the estimated rehabilitation costs cannot exceed 110% of the expected market value. The expected values are generally determined by an appraisal company using comparable sales in the same marketplace. In the loan files we examined, unrealistic comparable sales were used and some of the comparables were in different neighborhoods from the property to be insured. While these comparable properties may have been similar in size, they certainly were not comparable in value. Some of the 203(k) properties to be rehabbed were mere foundations. The completed rehabilitation would essentially be a totally new building. It became apparent in the investigation that the information present in the loan files was intended to deceive HUD.

Underestimated Rehabilitation costs The next step was to calculate the rehabilitation cost. We found that the lender generally backed into the rehabilitation number, in other words, the difference between the FHA mortgage limit and the cost for the flipped property. This could not have been done without the full cooperation of the appraisal company. In many of the cases under investigation, there was no real intention to complete the rehabilitation work. With the complicity of the lender, questions were not raised about the reasonableness of the proposed rehabilitation work. In fact, we found several instances where the total cost of the rehabilitation work was lowered by the lender to fit within the insurable mortgage limits. For example, one of the properties was a mere foundation wall. The rehabilitation worksheet called for the entire four unit building to be completed for about $35,000 per unit, not very realistic for New York City.

Underwriting Problems The direct endorsement lender plays a key role in assuring that the loan is underwritten to protect the interest of the FHA insurance fund. Many of the frauds in Harlem involved MLA, which is now out of business. Loan officers were receiving payments for creating the fraudulent loans. Lender employees helped to falsify the credit worthiness of certain not-for-profit buyers and then helped in altering the rehabilitation worksheets so the FHA loan could be made.

Fraudulent Closings We found a number of irregularities in reviewing the property closings. In a number of cases, a real estate attorney assisted the investor in flipping the property to the not-for-profit. We also found where the investor provided the not-for-profit funding to handle the costs of the down payment. The investors and lender employees provided the not-for-profits with selected attorneys for the closings. This assured that the fraudulent transactions would not be detected.

Example Transactions We would like to illustrate the impact of these schemes in the following two examples:

The first is a property at **157 E 121st Street** –The picture depicted on chart provided to the committee (taken from FHA Loan File) was taken in the fall of 1998. An investor purchased this abandoned building on December 18, 1998 for $60,000. Five days later, title to this property was transferred to a not-for-profit for $225,000 on a HUD secured 203(k) mortgage of $355,700. At that time the $225,000 in proceeds was divided among the conspirators. The remaining $130,700 was escrowed to pay rehabilitation costs. This property went into default in less than one year. This next picture was taken two weeks ago. Since it appears that no rehabilitation work was performed on this property, HUD's insurance loss will be substantial.

The second property is at **316 W 113th Street** –The picture depicted in the chart provided to the committee (taken from the FHA loan file) was taken in the summer of 1998. An investor purchased this lot with foundation on July 1, 1998 for just $35,000. Six days later, title to this property was transferred to a not-for-profit for $160,000 on a secured 203(k) mortgage of $327,400. At that time the $160,000 in proceeds was divided among the conspirators. The remaining $167,400 was escrowed to pay rehabilitation costs. This property quickly went into default. This next picture was taken two weeks ago. Since it appears that no rehabilitation work was performed on this property, HUD's insurance loss will be substantial. Since MLA is now out of business, any hopes of recovering the escrow funds on either of these properties are doubtful.

<u>HUD Single Family Operations in FY 98- "staff losses and turnover"</u>

When a scandal of this magnitude occurs, generally the first question is where was the HUD oversight. It is important that the Subcommittee understands that when these frauds were occurring in 1997 and 1998 employees were severely distracted. HUD was undergoing major operational changes in both programs and staffing. The "HUD 2020 Reform" effort was massive, impacting nearly every HUD employee and nearly every aspect of Departmental operations. As former HUD Secretary Cuomo described it in his transformation report, "We could not tinker around the edges, nor could we slowly retrace our steps, taking apart each program one by one to examine and fix the problems. Instead, we would have to start anew. So we began with a blank slate…" Our Semiannual Reports to Congress, starting in September 1997, highlighted our concerns over the disruption caused by this hasty reorganization effort.

Starting in late 1997, and throughout 1998, HUD's single-family program was at its most vulnerable point. Secretary Cuomo announced his "2020 Reform Plan" in June of 1997. Part of that plan involved the downsizing of HUD from its existing level of about 10,500 staff to 7,500 by the start of fiscal year 2002. (In late 1998, the goal of reaching 7500 staff was dropped). With Congressional buyout authority expiring at the end of calendar year 1997, the Department made a major push to use this authority to quickly downsize. About 1,000, mostly senior level, staff took the buyout and left HUD by the end of 1997. Those taking these buyouts were primarily Housing employees. Additionally, many positions within the Department were being abolished with this "new slate" and remaining employees were being forced to apply for positions in the "new" HUD. The focus of many employees time during this period was on survival, i.e. finding a new job outside of HUD or a position in the reorganized Department.

In our Semiannual Report to the Congress for September 1997, we expressed serious concerns over the rapid pace with which the HUD reforms were taking place. Here are a couple of excerpts from our report:

- "Many of HUD's technical staff experts and mid- and senior-level managers have already left the Department, taking with them vast institutional knowledge and program expertise that cannot be easily replaced."

- "In addition to our concern about the sufficiency of a 7,500 staff level, we are also concerned about the relative capacity of HUD's remaining staff to carry out their mission and responsibilities once reforms are in place. Not only is HUD losing significant staff expertise and managerial talent through downsizing, but many remaining staff members may be unfamiliar with their new positions. Thus, HUD may be faced with a lengthy transition period before staff are sufficiently trained and experienced to operate at full capacity."

The 2020 Plan's biggest impact on staffing was in single family housing operations. The Secretary felt that single-family operations could benefit the most from the automation of activities and the contracting out of certain functions. The Plan called for the consolidation of single family operations into four Homeownership Centers (HOCs). By early 1998, all of New York City's single-family operations had been transferred to the Philadelphia HOC. Before the "2020" reorganization in early 1997, there were close to 360 single-family employees located in those state jurisdictions now served by the Philadelphia HOC. Included in that number were 21 single-family staff in New York City. Today, there are about 210 employees in the Philadelphia HOC.

While staff was declining rapidly, HUD's workload was skyrocketing. In 1998, HUD experienced its largest growth in single-family origination activity and its largest inventory of foreclosed properties in more than 10 years. However, HUD's reduced capacity to handle the increasing workload was not always evident to the outsider. Direct endorsement lenders, that do the vast majority of originations, manage the entire origination process. Limited resources only impacted HUD's ability to oversee. Additionally, HUD lost its expertise about localities, as single-family staff was no longer located in the 80 field offices. Our audit reports during this 1997 and 1998 timeframe noted that HUD's monitoring was dismal. Another major issue, compounding the problems of the HOCs, was the growing problem with Real Estate Owned (REO). In 1997, the REO inventory was at its highest level in 10 years. HUD contracted with Management and Marketing (M&M) Contractors in early 1998 to manage this inventory.

This transition was a huge burden on HUD staff. Further exacerbating the problems was the 1998 bankruptcy of Philadelphia HOC's largest M&M contractor, Intown Properties.

While all this was happening, we continued to point out to senior HUD officials and the Congress, through our Semiannual Reports, that the 2020 Reorganization was creating chaos. We encouraged HUD to slow down and make sure that changes were cost beneficial. The Department used paid consultants to endorse their reform plan and for the most part, our concerns fell on deaf ears.

Growth of the 203(k) Program At the time of these problems FHA loans were originated in Harlem, the Department was making a push to expand homeownership opportunities. The national homeownership strategy of the Clinton Administration was to meet a homeownership goal of 67.5%. The 203(k) program was one of many tools that were available in meeting that goal. While the 203(k) program was created over 30 years ago, it was so complicated that very few lenders or borrowers used it. The Clinton Administration simplified the program so it could be used as an additional homeownership tool. It was seen as a particularly valuable tool for bringing homeownership back to older urban neighborhoods allowing a family to roll the costs of buying and fixing up an existing home into a single first mortgage.

HUD began an aggressive program of marketing and outreach for the 203(k) program in 1994. The program was seen as a cornerstone of HUD's revitalization strategy. Production goals were set for field offices and an aggressive effort was made to promote the program. With an average of about 3,000 203(k) mortgages per year in the early 1990's, activity jumped to 17,000 mortgages in fiscal year 1997. As the volume increased, there was no corresponding increase in oversight by HUD. In fact, with the struggles in setting up the new HOC structure, 203(k) oversight was not a high priority. Since the surge in activity in 1997, 203(k) activity has since fallen off. In 2001, HUD's activity will be about half of what it was in 1997.

OIG's Report on the 203(k) Program in February 1997 We performed a comprehensive audit of the 203(k) program and issued a report which focused on Investor and Non-Profit abuses of the program. The problems noted in this report were exactly the same problems found in Harlem. Here is an excerpt from the executive summary of that report:

> "Our results show that non-profit and investor borrowers have carried out fraudulent or otherwise unnecessary land and refinance transactions to generate money for either the borrower or identity-of-interest parties. They have not made required downpayments. They have obtained loans on properties which did not need significant repairs and should not have been in the program. Investors have been paid for rehabilitation work that was not performed. Non-profit borrowers have obtained large numbers of loans and have been unable to complete the work. Non-profit borrowers have also made large profits, contrary to their stated motivation. Unfortunately, mortgage lenders have contributed to the abuse."

In reaction to our audit work, the Department put a moratorium on investor participation in 203(k) mortgages. However, because of the importance of the program to HUD's revitalization strategy, the Department did not want to stop non-profits from program participation but promised to tighten up on program rules. Unfortunately, while the moratorium was in place and while HUD was working to tighten the rules, many investors saw this as an opportunity to use existing non-profits or create fictitious non-profits to continue abusing the program.

A purchase/rehabilitation mortgage insurance program is inherently complex and requires a substantial training and monitoring commitment from HUD and the lender to assure that transactions are made that pose the least risk to the insurance fund. Small programs, like the 203(k) program, take a huge amount of resources to effectively manage. As I noted earlier, major distractions impacted on HUD's ability to oversee an impending disaster.

GAO's June 1999 report on the 203(k) Program further confirmed that HUD was doing little to address the problems. Their report stated: "Despite the recognized risk associated with the 203(k) program and the potential for mounting losses to the General Insurance Fund, HUD has done little to address the problems identified by its Inspector General and others."

The American people are committed to investing hundreds of millions in poor neighborhoods to make them decent, good places to live. In Harlem, religious and other not-for-profit organizations working in partnership with criminals aggressively pilfered nearly the entire investment that had been set aside to help vulnerable and disadvantaged elements of our society. HUD's very poor management allowed this slow moving theft of huge proportions to go undetected, until it was too late.

In March 2000, HUD took action to limit the number of 203(k) properties for each non-profit to ten incomplete developments. HUD also took action to strengthen the non-profit approval and re-certification processes. HUD and the OIG will carefully track the progress of reforms on the 203(k) program and keep the committee apprised of the effectiveness of those reforms.