STATEMENT OF
KENNETH DONOHUE, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE UNITED STATES
HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON HOUSING
AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
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Chairman Ney, Ranking Member Waters and other members of the Subcommittee, it is my pleasure to testify before you today on the HUD Inspector General perspective on mortgage fraud and its impact on financial institutions.

My perspective on mortgage fraud is based on our work with HUD's Federal Housing Administration, commonly known as "FHA." As you know, there are three general types of mortgages: FHA insured, Veterans Administration guaranteed, and conventional. Of all homes purchased in the United States each year, 8% are financed with FHA mortgage insurance. Additionally, each year FHA accounts for 30% of all insured mortgages. FHA insured mortgages may be more prone to mortgage fraud because FHA insures mostly first-time homebuyers with limited credit histories and little money down. First-time homebuyers account for about 75% of FHA's new endorsement business and about half of its customers fall at, or below, the medium income in the area. Most of these FHA borrowers cannot qualify for a conventional loan.

HUD has a portfolio of nearly 5 million FHA insured mortgages with an unpaid principal balance of $418 billion as of the end of July 2004. For the first 10 months of fiscal year 2004, FHA endorsed about 875,000 mortgages. However, FHA activity has fallen off nearly 20% from the same period a year ago.

A closer look at the makeup of the FHA portfolio would indicate that FHA's insurance risk is increasing. A comparison of active insured FHA cases to FHA claims cases over the past two years shows an increasing claim rate. The claim rate for fiscal year 2003 was 1.58%. This rate is up 74% from a .91% rate in fiscal year 2001. As you can see from our chart, our investigative workload is increasing with more than 450 open criminal single-family investigations and our arrests in the single-family mortgage area have increased by 800% in a four-year period. We believe there is a direct relationship between our increasing workload and FHA's increasing claims rate.

Additionally, more low down payment business is moving to the private sector. Whereby FHA was once the only low down payment mortgage available to borrowers, now the conventional marketplace has new mortgage products available to these borrowers. The borrowers beginning to use these new conventional products would normally be considered FHA's better customers.

Annual Financial Audit

The annual audit of the Federal Housing Administration's financial statement has found the FHA in basically sound fiscal condition. FHA continues to exceed its minimum capital ratio requirements as set by the Congress. This financial health has been brought about by a robust economy and mortgage premium income, which has far exceeded the cost of claims each year. Nevertheless, FHA's claims rate continues to rise each year and with fewer FHA mortgage applicants there is less premium income to cover the claims. The default rate (mortgages more than 90 days delinquent) for the FHA insurance-in-force portfolio has nearly doubled in the last five years, from 3% to almost 6%.

FHA's loss mitigation tools help many of these defaulted loans from moving to foreclosure. Loss mitigation usage is up 16% from a year ago. Despite these loss mitigation tools, however, we continue to see a rise in claims. A future economic downturn and/or future interest rate increases would provide opportunities for those who would prey upon homeowners who cannot make their mortgage payments.

Types of Mortgage Fraud in FHA Programs

In the recent past, we have conducted hundreds of audits of mortgage companies offering FHA loans and investigated thousands of cases of mortgage fraud. We repeatedly have found unlawful and deceptive practices and outright fraud in mortgage lending that often exploit first-time and uninformed FHA borrowers. Some of these practices include:

- Appraisers valuing properties for much more than they are worth.
- Loan officers falsifying income and credit documents.
- Lenders charging fees for services not provided or unnecessary.
- Realtors deceiving the potential homebuyer of the property condition.
- Borrowers duped into re-financing their mortgages over and over until the equity is completely stripped from the property.
- Using stolen or purchased social security numbers and/or credit histories.

Of particular concern is the illegal profiteering on the purchase and quick resale of homes called "property flipping."   The illegality arises because one or more parties to the transaction (seller, loan officer, appraiser) conspire to inflate the value of the home and then pocket the excessive profits at loan closing. What is the impact – who gets hurt?

- Once the borrower knows the true value of the property, they abandon the property.
- Neighborhoods deteriorate as the number of abandoned properties increase.
- Remaining homeowners are stuck making payments on inflated mortgages.

Another concern is "equity skimming." A common form of equity skimming involves an investor who exploits a homeowner facing foreclosure and other financial stress. How is this done?

- Investor offers to resolve the financial problems if the homeowner gives up ownership or an ownership share in the property.
- Homeowner agrees to pay rent to the investor and the investor promises to make the mortgage payments.
- Investor pockets the rent and makes no mortgage payments.
- Lender forecloses on the homeowner (investor's ownership interest not recorded).
- Investor uses bankruptcy laws to stay foreclosure.

Calculating Fraud?

Mortgage frauds can go undetected and not all fraud results in losses to the government. This makes it difficult to quantify the exact amount, or even an estimated amount, of mortgage fraud. The following scenarios highlight the difficulties -- for example: 1) the appraiser that was pressured by the lender for a higher appraised value to match the sales price; 2) the homebuyer that submits false down payment gift letters; 3) the seller that works a side loan with the buyer in order to make the deal work; or 4) the loan processor that overlooks a known debt that is not on the credit report. These things happen everyday and all would be categorized as mortgage fraud, and these can go undetected unless the borrower defaults on the loan, or there is a pattern of defaults associated with a particular lender, realtor, or appraiser. Complicating every case of fraud is proving the perpetrator did it intentionally and showing a significant loss to the Government.

If there are any significant miscalculations in the underwriting process, i.e., overstatement of income or understatement of debt, this would normally manifest itself in a payment delinquency on the mortgage. Every month, one out of every nine FHA mortgages is reported as delinquent. That means 600,000 FHA borrowers are a month behind in paying their mortgage. Some portions of these delinquencies may be due to mortgage fraud in new mortgages, where the underwriter intentionally misrepresented the borrower’s ability to pay the mortgage.

We are continuously monitoring the status of defaulted loans in the FHA portfolio. These statistics are used by the OIG and the Department’s Quality Assurance Division to identify specific lenders for review with above average defaults. We also provide outreach to the mortgage industry, talking with real estate agents, brokers, appraisers, lenders and servicers. We routinely receive referrals from one of these parties that are aware of fraudulent activities.

Some Examples of Specific Frauds

Below are two examples of combined OIG and FBI investigations of property flipping frauds and the results of a recent audit of mortgage fraud.

- **Chicago, IL.** ***The key players: an investor, an appraiser, and the settlement attorney***.

These three conspirators preyed on unwitting FHA borrowers in Chicago's south and west sides, saddling the new homeowners with overvalued properties and unmanageable mortgage debt. The fraud scheme was a typical flip. The investor would contract to purchase a property, recruit homebuyers, and then partner with a crooked appraiser and attorney to complete the resale and closing at an inflated price. The closings, some 70-80 properties, were done on the same day. The settlement attorney would close the sale to the FHA borrower first, then use the proceeds to pay off the first (and legitimate) seller, backdate closing documents to give the appearance of propriety, and ensure that all parties to the scheme were paid out of the FHA insured loan. *As you can see from the pictures on the easel, this example of one of the properties shows how significantly it declined in appearance and how it could potentially impact the surrounding neighborhood when one of these fraudulent transactions occurred*.

In the end, the investigation resulted in 20 people indicted on 16 different counts, including mail fraud, wire fraud and false statements to HUD. Eighteen individuals pleaded guilty. The attorney and the appraiser went to trial and were convicted on all counts. The attorney was sentenced to 7 years imprisonment and the appraiser received 40 months. HUD's cost: $7 million in insurance losses.

- **Stone Mountain, GA.** ***The key players: an appraiser and the settlement attorney***.

Earlier this year, a 158-count indictment was handed down in the Northern District of Georgia. The charges: wire fraud, bank fraud, money laundering, conspiracy, identity theft, use of false social security numbers and making false statements to HUD, all related to a mortgage fraud scheme involving a $20 million portfolio.

From mid-1999 through March 2004, it was alleged that the settlement attorney and co-conspirators perpetrated a property flipping scam. The attorney owned and operated a law firm, acted as agent for title insurance companies, and was the closing attorney for various lenders.

Again, the ‘flipping’ fraud was familiar. The defendants purchased residential properties primarily in the Stone Mountain, GA vicinity and resold them at artificially inflated prices, using the proceeds of the resale to pay for the initial purchase. The defendants would use identity theft or recruit “straw sellers” to falsely claim current ownership of the properties. The properties, in turn, were sold to straw borrowers at amounts fraudulently inflated. Put simply: the deals and documents were faked. The conspirators signed ghost or fake names as loan officers and processors of the mortgage company. They falsely notarized and witnessed the names of straw buyers and sellers who neither attended closings nor signed the closing documents. And, they created shell companies to falsify straw borrower employment, to receive scheme proceeds, and to pay, and otherwise, reward bank employees for providing false and misleading Verifications of Deposit. HUD’s cost: $3 million in insurance losses.

- **Phoenix, Arizona Audit**

In a recent audit of an FHA-approved lender, we found the lender was fabricating or altering borrower credit and employment documents to make the loans approvable. In this audit we found pervasive document falsifications in 48 of 65 (74%) FHA loans originated by a HUD approved correspondent lender in the greater Phoenix metropolitan area. What was instructive about this audit was that only one loan officer was primarily responsible for originating the falsely documented loans. What is also alarming is the potential damage that resulted. The insurance value of these 48 loans exceeded $5 million. The lender ignored its responsibilities to HUD by not having a quality control plan in place. Consequently, this loan officer continued to originate FHA loans using false documents over a three-year period. In our opinion, performing quality control is the first line of defense in assuring that only qualified borrowers get loan approval. Sadly, for some lenders, quality control only becomes a concern after the auditors have detected the problem.

Conclusion

When we identify fraudulent transactions, we take a look at the cause of the problem. If additional controls are warranted, we make recommendations to the Department. If the problems result from criminal activity among parties to the FHA transaction, we present these matters to the US Attorney’s office for prosecution. Problem lenders are brought before HUD's Mortgagee Review Board for sanctions. There are many actions we can take if the fraud is brought to our attention. However, the mortgage industry is huge with millions of dollars of FHA loans being endorsed each day. Statistics are pointing to increased levels of risk. In the Office of Inspector General, we are making every effort to use our limited audit and investigative resources as efficiently and effectively as possible in combating mortgage fraud. We continue to work with our partners in the FBI and Justice Department, as well as with state regulatory and law enforcement agencies, to decrease mortgage fraud.

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Chairman Ney, I appreciate the Subcommittee's concern over the increasing problem of mortgage fraud. The result of these types of financial crimes undermines the confidence in this nation's housing industry and frustrates honest Americans' dreams for home ownership. In addition, the victims include the honest mortgage company employees that lose their jobs because they are victimized by the unsavory business practices of other staff, the homebuyers whose credit was destroyed when they had to default on a loan that they really could never afford in the first place, or the new FHA homebuyer that is paying a higher than necessary mortgage premium to cover growing losses to the insurance fund.

Thank you for the opportunity to express our views on this critical issue.