Testimony Before the
United States Senate
Committee on Appropriations
Subcommittee on Transportation, Housing and
Urban Development and Related Agencies

An Overview of the Federal Housing Administration

★ ★ OFFICE *of* ★ ★
INSPECTOR GENERAL
UNITED STATES DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT

Testimony of
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June 4, 2013
2:30 p.m.

Chairman Murray, Ranking Member Collins, and members of the Subcommittee, I am David A. Montoya, Inspector General of the U.S. Department of Housing and Urban Development (HUD). Thank you for the opportunity to discuss the oversight of the Department that my office conducts and current issues relating to the Federal Housing Administration (FHA).

As part of the Department's primary mission to create strong, sustainable, inclusive communities and quality, affordable homes for all, HUD also assists families in obtaining housing by providing FHA mortgage insurance. HUD is an important spoke in the Nation's housing industry in that FHA-insured mortgages finance approximately one-fourth of all home purchases in the United States.

Since becoming the Inspector General, I have had an ongoing dialogue with FHA Commissioner Carol Galante on the challenges that the Department and FHA face and the work my office has done in its oversight capacity.

In a very coordinated effort, the Department and Office of Inspector General (OIG) worked collaboratively to achieve a historic result with last year's national mortgage settlement of more than $25 billion – the largest consumer financial protection settlement in U.S. history. We are building on that success and have undertaken an initiative to review fraudulent loan originations made by some of the Nation's largest mortgage companies in the FHA program. These endeavors showcase the accomplishments that we are engaged in, not only with the Department, but also working closely with the U.S. Department of Justice (DOJ).

While I continue to support our activities relating to these reviews, I also endeavor to manage my limited resources to provide proper oversight of the many other programs and operations within the Department and its role in responding to Hurricane Sandy and other disasters. The following testimony highlights some of the more pressing issues facing the Department's administration of the FHA program, particularly in light of its increased role in the marketplace.

A History of OIG Concerns and FHA's Slow Response

HUD OIG has consistently expressed its concerns over the years about the level of oversight and risk taken on by FHA and the effect on its financial health. Unfortunately and for a number of reasons, FHA has been slow to respond to many of our recommendations and has only recently finally implemented some of them. For example, it has been noted that while seller-funded downpayment-assisted loans have been prohibited since the end of 2008, OIG has expressed its concern to FHA over the negative impact of seller-funded downpayments on FHA as far back as 1999. Loans using seller-funded downpayment assistance have proven to place a substantial stress on FHA's Mutual Mortgage Insurance (MMI) Fund.

OIG completed its first comprehensive analysis of seller-funded downpayments in March 2000, looking in depth at this and the associated program risks, as these loans increasingly began to consume a larger share of FHA loan originations. We concluded that HUD allowed nonprofit organizations to operate downpayment assistance programs that circumvented FHA requirements. The downpayment loan transactions did not meet the intent of FHA requirements in that the downpayment assistance was not a true gift from the nonprofit; sellers raised the sales price of properties to cover the cost of the seller-funded downpayment assistance, causing buyers to finance higher loan amounts; and default rates for buyers receiving downpayment assistance from nonprofit organizations were significantly higher than for other FHA loans. We recommended back then that HUD implement a proposed rule to eliminate seller-funded nonprofit downpayment programs.

Our long-term concerns and findings were later validated by several FHA-commissioned studies and by a U.S. Government Accounting Office (GAO) study in 2005, 6 years after we first raised concerns. However, FHA still resisted implementing our recommendation, in part because the change would have required the Department to go through the rulemaking process and there were concerns about whether FHA would prevail. More significantly, however, was FHA's concern at the time about the impact such a change would have on its market share. By 2006, the concentration of nonprofit downpayment assistance had approached 25 percent of FHA's new business portfolio, including purchase and refinance loans. FHA did not act to end the practice until 2007, and then legal challenges caused further delay. Ultimately, legislation to disallow the practice was enacted in 2008, too late to prevent the looming losses we are now seeing.

The legacy of this delayed inaction reverberates today as seller-funded downpayment-assisted loans continue to place significant stress on the MMI Fund. According to HUD's fiscal year (FY) 2012 report on the financial status of the fund, these loans account for only 4 percent of the outstanding portfolio but are 13 percent of all seriously delinquent loans. Over the life of the loans, seller-funded downpayment loans are expected to cost the MMI Fund more than $15 billion.

Similarly, in 2007, FHA was pressing for "reform" legislation that, among other things, would have raised loan limits and allowed FHA to insure loans with no borrower downpayment requirement. At the time, FHA's share of the mortgage market had fallen to less than 4 percent of the total market and less than 2 percent of the total dollars for mortgages originated in the United States. Indeed, with the ready availability of conventional subprime financing, FHA was perceived as becoming increasingly irrelevant, and the primary concern at FHA was to find ways to increase its market share. It focused more on marketing FHA loans than on instituting sound risk management and lender oversight.

HUD OIG testified in March 2007 and expressed its concern as to whether FHA was headed in the same direction as the subprime market with its seemingly continued deregulation and introduction of "riskier" products as part of its proposed reform. FHA seemed to have lost sight of the fact that since its inception, it has played a cyclical role in the housing market, sometimes gaining market share in times when it was needed to bolster the market and sometimes losing share when the conventional market place was addressing the constituency that FHA has always focused on: low- to moderate-income and first-time potential home buyers. However, this always remained true; whether in the conventional or government mortgage programs, no loans should have been given if the purchaser was unable to pay back the loan.

Finally, in April 2009, when the effects of the economic crisis and collapse of the housing market were becoming more and more ominous, OIG testified before this Subcommittee and expressed its concern about the impact of FHA's precedence-setting increased market share and HUD's ability to manage the increased workload with its limited and stagnant resources. FHA was also taking on new risk that needed to be managed. As an example, the Housing and Economic Recovery Act of

2008 authorized changes to FHA's Home Equity Conversion Mortgage (HECM) program that enabled more seniors to tap into their home's equity and obtain higher payouts. This office, at the time, raised concerns about HUD's ability to provide proper oversight as there was a critical need for more resources for FHA. Those resources were needed to (1) enhance its information technology (IT) systems; (2) increase its personnel to meet escalating processing requirements; (3) increase its training of personnel to maintain a workforce with the necessary skills to deal with the responsibility of this new portfolio; (4) oversee the many contractors it maintained; and (5) increase its oversight of all critical front-end issues, including such important areas as the appraisal, lender approval, and underwriting processes.

The HECM program was originally projected to be profitable for FHA but has turned out to be a substantial drain on the insurance fund. I will discuss the HECM program in more detail later in my testimony. While Secretary Donovan and FHA Commissioner Galante are proactive and supportive of OIG and its recommendations, I have to note, as described above, that FHA's reluctance over the years to more quickly deal with its looming issues has taken a toll, a toll we are only now beginning to understand. FHA has been trying to improve its financial position in recent years with legislative and regulatory proposals. But as we said years ago at the beginning of the subprime crisis, movement in the Department is more like turning an ocean liner than driving a fast boat through the tempests and currents of an ever-changing mortgage market.

A recent example of FHA's apparent inability to quickly react to changing conditions can be seen in its efforts to require lenders to indemnify HUD for serious and material violations of FHA origination requirements and for fraud and misrepresentation in connection with the origination of FHA loans. Historically, HUD has sought such indemnifications through agreement with the lenders. HUD already possesses the statutory authority to require such indemnifications for lenders participating it its Lender Insurance program and issued a proposed rule in October 2010 to, among other things, provide additional guidance on HUD's regulations implementing this authority. The rule was not finalized until January 2012, and the mortgagee letter to implement the change in policy was not issued until a month ago on April 10. According to the mortgagee letter, the revised indemnification policy is effective for all loans insured by Lender Insurance program lenders on or after that date. Thus, 2½ years have passed since the rule was proposed, and it remains to be seen whether this will be an effective tool in recovering losses since FHA's homeownership centers have yet to implement the change. To further exacerbate this situation, since 2010, HUD has been seeking statutory authority to require indemnifications from the remaining 70 percent of its direct endorsement lenders that do not participate in the Lender Insurance program.

Based on OIG's experience in dealing with FHA over the years, we remain concerned about HUD's resolve in taking the necessary actions going forward to protect the fund. HUD is often hesitant to take strong but needed actions against lenders because of its competing mandate to continue FHA's role in restoring the housing market and ensure the availability of mortgage credit and continued lender participation in the FHA program. Nevertheless, OIG has generally been supportive of FHA's initiatives to raise premiums and better manage its risk, including the establishment of its Office of Risk Management. Similarly, we strongly agree with HUD's position that FHA needs legislative changes to afford it greater flexibility to make changes to its policies and procedures as history has shown that it needs to be able to react more quickly to market changes and avoid losses that can accrue during a lengthy rulemaking process. In this light, my office is developing its own set of recommended legislative initiatives that we believe can further strengthen FHA's ability to mitigate risk and recover losses to the insurance fund and enhance OIG's ability to address fraud, waste, and abuse in the program. We will be vetting these proposals with FHA and the appropriate committees.

Financial Health of the FHA Mutual Mortgage Insurance Fund

FHA's MMI Fund is the largest of its four mortgage insurance funds. The fund consists of a system of accounts used to manage FHA's single-family mortgage insurance programs. The Cranston-Gonzalez National Affordable Housing Act of 1990 mandated that the MMI Fund maintain a capital ratio of 2 percent from October 1, 2000, forward. The capital ratio is defined as the ratio of the Fund's economic value to its insurance in force. The economic value essentially represents capital that is exceeds the amount needed to cover anticipated losses. Clearly, when establishing this mandate, Congress voiced its concerns that some sort of cushion was important to maintain. The capital ratio has been below this required 2 percent level for the past 4 years, and each year has seen a further decline in the ratio to the point at which, based on the latest actuarial study in November of last year, the ratio has fallen below zero to negative 1.44 percent, which represents a negative economic value of $16.3 billion. The economic value of the forward portfolio was estimated at negative $13.5 billion and the HECM portfolio at negative $2.8 billion. These economic values represent capital reserve ratios of negative 1.28 percent and negative 3.58 percent, respectively.

Over the last several years, FHA has increased premiums and taken other steps to restore the financial health of the MMI Fund. Nevertheless, based upon FHA's deteriorating financial condition, in February 2013, GAO included FHA concerns in its "high risk" section relating to "Modernizing the U.S. Financial Regulatory System and Federal Role in Housing Finance." It was not FHA itself that was deemed a high risk but, rather, FHA as part of the larger high-risk concern over the Federal role in housing finance.

While we acknowledge the Department's actions to address the MMI Fund's finances, my office remains concerned about whether the actions are enough to make up for the losses FHA has sustained and to reach the required 2 percent level anytime in the near future. For example, FHA is now using credit scores as part of the eligibility requirements for FHA loans. As of October 2010, borrowers with credit scores below 500 are no longer eligible for FHA insurance, and the maximum loan-to-value ratio for borrowers with credit scores between 500 and 579 is 90 percent. At the time these changes were being proposed, we expressed our overall support but also took the position that the changes did not go far enough and would likely have minimal impact on the MMI Fund in terms of bringing in additional premiums. While FHA enacted increased downpayment requirements for borrowers with credit scores below 580, we noted that loans for borrowers with credit scores below 580 were less than 1 percent of new activity. Moreover, the 580 credit score threshold is well into what is traditionally considered subprime territory in the conventional marketplace. A higher downpayment requirement at the appropriate credit score level would force borrowers to have more personal stake and financial exposure, which we believe would have a more meaningful impact in protecting the Fund due to the larger volume of loans at higher credit score levels. The more a borrower is personally financially invested in a loan, the more unlikely he or she will be willing to give up on the investment.

As shown in the charts below from data we obtained from HUD's systems as of April 12, 2013, FHA has experienced high levels of claims in recent years compared with levels seen before the financial crisis. For purposes of illustration, the following chart reflects total FHA insurance claims from calendar years 2005 through 2008, the year that the current financial crisis began.

FHA Insurance Claims
2005 to 2008

Year	Forward Mortgage Claims		Home Equity Conversion Mortgage Claims		Loss Mitigation Claims		Total	
	Claims	Amount Paid	Claims	Amount Paid	Claims	Amount Paid	Claims	Amount Paid
2005	68,455	$6,562,000,000	1,187	$87 ,000,000	75,407	$119,000,000	145,049	$6,768,000 000
2006	57,243	$5,595,000,000	1,514	$143,000,000	82,365	$170,000,000	141,122	$5,908,000,000
2007	54,556	$5,629,000,000	2,257	$256,000,000	84,758	$150,000,000	141,571	$6,035,000,000
2008	62,440	$6,981,000,000	3,149	$381,000,000	104,092	$204,000,000	169,681	$7,566,000,000
TOTAL 2005 to 2008	**242,694**	**$24,767,000,000**	**8,107**	**$867,000,000**	**346,622**	**$643,000,000**	**597,423**	**$26,277,000,000**

The following illustration reflects total FHA insurance claims from calendar years 2009 (after the beginning of the financial crisis) through 2012.

FHA Insurance Claims
2009 to 2012

Year	Forward Mortgage Claims		Home Equity Conversion Mortgage Claims		Loss Mitigation Claims		Total	
	Claims	Amount Paid	Claims	Amount Paid	Claims	Amount Paid	Claims	Amount Paid
2009	83,881	$10,163,000,000	4,652	$567,000,000	131,115	$268,000,000	219,648	$10,998,000,000
2010	119,830	$15,654,000,000	5,681	$559,000,000	208,876	$411,000,000	334,387	$16,624,000,000
2011	118,475	$15,144,000,000	8,684	$928,000,000	173,163	$563,000,000	300,322	$16,635,000,000
2012	155,266	$20,245,000,000	14,207	$1,432,000,000	142,551	$660,000,000	312,024	$22,337,000,000
TOTAL 2009 to 2012	**477,452**	**$61,206,000,000**	**33,224**	**$3,486,000,000**	**655,705**	**$1,902,000,000**	**1,166,381**	**$66,594,000,000**
GRAND TOTAL 2005 to 2012	**720,146**	**$85,973,000,000**	**41,331**	**$4,353,000,000**	**1,002,327**	**$2,545,000,000**	**1,763,804**	**$92,871,000,000**

As reflected in the charts above, the amount FHA paid in claims during the last 4 years was about 2½ times the amount paid during the preceding 4 years ($66.6 billion vs. $26.3 billion). The total amount of claim payments rose substantially in 2009 and has continued to increase.

Apart from the obvious financial implications, this situation creates a challenge for FHA, since the Prompt Payment Act requires HUD to pay the claim on a defaulted FHA-insured mortgage within 30 days and only then can it go back to the lender that underwrote the loan to recover losses incurred if it finds that the loan was ineligible for insurance. Thirty days is an insufficient amount of time for HUD to determine whether a loan was ineligible for insurance due to fraud or misrepresentation in the loan origination process. The result of this requirement places HUD in a "pay and chase" situation as our past audits have expressed concern over HUD's exposure when paying claims on loans that were not qualified for insurance. In addition, FHA has been resistant and slow in implementing a rigorous claim review process and to recover losses from lenders instead relying primarily on a strategy to focus efforts on loans that had not reached claim status. FHA only recently agreed with recommendations we made as far back as 2006 and again in 2011 to review all loans for which a claim was paid within the first 24 months, claims we define as high-risk claims. This matter takes on even greater importance in light of the significant amount of claims projected to be filed by lenders in the coming months and HUD's current limited capacity for reviewing submitted claims.

In addition to the unprecedented levels of claims noted above, FHA can expect to see a continuing influx of claims in the foreseeable future. The latest FHA-reported default rate (seriously delinquent loans) as of January 2013 stood at 9.49 percent. By comparison, the default rate in September 2008 was 6.91 percent. Based on our analysis of FHA data, the total unpaid balance of FHA single-family loans in default now exceeds $100 billion.

FHA Loans in Default (3 months or more delinquent) as of March 31, 2013

Loans	Unpaid Balance
724,173	$103,324,000,000

While FHA has taken a position that its current losses are primarily from loans made from 2007 to 2009, it continues to project that the current and future years' books of business will be profitable and make up for these past years' losses. However, what we have seen in the past 4 years is a troubling trend, whereby the point at which the MMI Fund is expected to reach its mandated capital level is pushed farther into the future. In the FY 2009 independent actuarial study, it was predicted that by the end of FY 2011, the MMI Fund's capital ratio would be 1.74 percent and that the MMI Fund would meet the 2 percent mandate sometime during FY 2012. In the following 3 years, that forecast has changed dramatically as the capital ratio has continued to move in the wrong direction and is now negative. In addition, we now have concerns about the FY 2010 and 2011 books of business as their profitability appears to be lower than projected and budgeted, as indicated and supported in the FY 2014 Federal Credit Supplement to the Budget, although not as substantially different as the reestimates from the earlier years of 2007 to 2009.

Based on current projections, the capital ratio will not reach the 2 percent level until 2017, marking 8 years below the 2 percent threshold. Moreover, these estimates are heavily influenced by the pace at which housing prices will recover. Any additional slowdown in the housing market will increase FHA losses and further delay FHA's ability to meet its statutorily mandated

2 percent requirement. We continue to work with FHA to ensure that it is instituting sound risk management and lender oversight practices to avoid further exposure of the MMI Fund to losses.

My office also continues to stress that the FHA actuarial model is complicated and difficult to audit, use, and employ for risk management and strategic planning purposes. The model inhibits frequent updates as well as the ability to understand changes in specific programs or risk categories. Ultimately, its current design and objective are to be in statutory compliance and do not promote FHA's timely use of policy corrections based on products, cohorts, or risk classifications for current or interim benchmarking decisions. While we have recommended modeling at the midterm or quarterly, which we believe would provide FHA a better basis for timely policy corrections and assessing the actuarial value of the MMI Fund, the model cannot be easily changed because it is proprietary and owned by the actuarial firm. I continue to have discussions with the FHA Commissioner regarding these issues.

With regard to one recent change in the modeling, the 2012 actuarial study applied a stochastic method to estimate the net present value of future cash flows. This was done to a large extent because of recommendations by OIG and GAO, recommendations that had been made for some years before 2012.

Home Equity Conversion Mortgage Program

The FHA HECM program is the only government-insured reverse mortgage program. The HECM program guarantees that the lender will meet its payment obligations to the homeowner, limits the borrower's loan origination costs, and insures full repayment of the loan balance to the lender up to the maximum claim amount; that is, the lesser of the appraised value at origination or the national HECM loan limit of $625,500. HECM insurance endorsements in FY 2012 were down by 25 percent from FY 2011 levels to 54,591. FY 2012 marks the third consecutive year in which HECM volume has declined. Yet, with a declining HECM demand, FHA asserts that the FY 2014 budget request for $943 million is largely due to the existing HECM portfolio. This product, particularly as it has been structured to date, is sensitive to home prices and economic conditions. This condition has resulted in a negative value of $5.248 billion and a disproportionately negative impact to the MMI Fund from the HECM program.

FHA is proposing, either through the granting of the legislative authority described below or via the much longer rule-making process, the following measures:

- Limiting the draw at origination to mandatory obligations,
- Addressing the issue of non-borrowing spouse language in the FY 2015 budget,
- Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation, and
- Establishing a tax and insurance set-aside to ensure that sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

While OIG supports these proposed changes, it continues to raise concerns about FHA's belated actions. Since 2008, OIG has been proposing similar changes to the HECM program based on results of its audit and investigative work. The four OIG reports discussed below identified problems with reporting borrowers' deaths, payment of required property taxes and insurance, reliability of financial data, and compliance with the HECM residency requirement.

A 2008 audit found that HUD did not ensure that FHA lenders reported HECM borrowers' deaths in accordance with Federal requirements. HUD could not be assured that FHA lenders appropriately met HUD's time requirement for initiating the foreclosure process or recording the deeds-in-lieu to take possession of the property, which impacted the amount of the lender's insurance claims.

In an internal audit issued in August 2010, we determined that HUD had not tracked almost 13,000 defaulted HECM loans with maximum claim amounts of potentially more than $2.5 billion. The audit found that an increasing number of borrowers had not paid required taxes or homeowner's insurance premiums, thus placing the loan in default. We noted that HUD granted foreclosure deferrals routinely on these defaulted loans but it had no formal procedures to do so. HUD's informal foreclosure deferral policy had a negative effect on the universe of HECM loans and loan servicers. After cancelling its informal policy, HUD did not issue guidance to servicers advising them of what action to take regarding defaulted loans. Thus, servicers continued to service the loan and paid the taxes and insurance for the borrowers without notifying HUD. As a result, four servicers contacted were holding almost 13,000 defaulted loans with a maximum claim amount of more than $2.5 billion, and two of the four servicers said they were awaiting HUD guidance on how to handle them.

The servicers had also paid approximately $35 million in taxes and insurance on these loans. HUD was unable to identify the deferred or defaulted loans in its system and did not track the number of borrowers who were unable to pay their taxes or insurance premiums. Since unreported defaulted loans were only obtained from 4 of a total of 16 HECM servicers nationwide, more defaulted loans may have existed. Since HUD could not track these loans, it did not know the potential claim amount in the event of foreclosure of about 7,700 loans of which HUD was aware and about 13,000 loans of which it was not aware and could lose an additional estimated $1.4 billion upon the sale of the properties.

In June 2011, we issued a report on HECM loan payments made after the death of the borrower. Our results indicated a few instances in which unscheduled advance payments were made after the death of the borrower, which resulted in claims paid by HUD, although we did not believe this was a systemic problem. In most cases, we found that scheduled payments were not actually made after the death of the borrower but were incorrectly recorded in HUD's Insurance Accounting Collection System by the lenders. More noteworthy was the fact that loan proceeds from the sale of property and claims paid by HUD were not credited to the HECM loan balances in a timely manner, resulting in inaccurate information being reported to HUD, causing unreliable financial data to be used by HUD. This evaluation also noted instances in which HECM loan servicing files contained indications of suspicious or potentially fraudulent transactions; however, there was no evidence that such matters were referred to HUD for further action. Lender officials stated that HUD's guidance in this area was too broad and that specific fraud indicators should be included in any future guidance.

Finally, in an internal audit issued in December 2012, we found that HUD policies did not always ensure that borrowers complied with program residency requirements under the HECM program. A review of 174 borrowers indicated that 37, or 21 percent, were not living in the property associated with the loan as required by the residency requirement to participate in the HECM program. These 37 loans were ineligible and should have been declared in default and due and payable to reduce the potential risk of loss of about $525,000 to HUD's insurance fund. These 37 loans had already been advanced $5.8 million, with the $525,000 remaining to be disbursed, although the borrowers were not living in the home.

In addition to the above-mentioned audits and reviews, the OIG Office of Investigation completed a number of criminal cases in which the criminals used elderly straw buyers to obtain HECM loans.

Due to the negative value of the MMI Fund, OIG plans to work closely with FHA in obtaining its proposed changes to the HECM program and in furthering other OIG-recommended changes to the program.

OIG Efforts to Recover Losses and Address Fraud Against the MMI Fund

As noted earlier, FHA has taken various measures to restore the financial health of the MMI Fund. OIG has also played an active role in this regard by aggressively pursuing and recovering losses from lenders that were engaged in questionable and often fraudulent underwriting of FHA loans. In the early part of 2011, OIG, in partnership with HUD and DOJ, initiated a number of mortgage lender reviews, whereby statistical samples of claims, defaults, and all other loans were drawn to determine the accuracy and due diligence of the underwriters of FHA loans by a number of the Nation's largest lenders. The reviews completed to date have resulted in a total of $1.24 billion in civil settlements for alleged violations of the False Claims Act and for failure to fully comply with FHA requirements. Some of these settlements involved some of America's largest lending institutions.

The loan-level reviews OIG has been conducting and which have resulted in large civil fraud settlements with major lenders are on the order of what we would expect HUD to be doing for itself as an inherent program responsibility. Examples of these activities include (1) reviews of seriously delinquent loans before claim submission and terminated loans upon claim submission for origination and misrepresentations and (2) claim mitigation in which claims are reviewed for documentation issues, violations of servicing requirements, and potential collateral-related defects. These examples are normal and expected practices in the private mortgage insurance sector. This issue relates to earlier comments about FHA's resistance to and slowness in implementing a rigorous claims review process and going back to the lenders to recover losses instead relying primarily on a strategy to focus efforts on loans that had not reached claim status.

OIG continues to aggressively review lender origination and underwriting practices as part of its ongoing oversight efforts in a housing market that for years was reckless about lending money. Imprudent business practices became a pervasive problem, and now those loans underwritten during that time are having a significant negative impact on the MMI Fund. The result has been a dramatic increase in mortgage delinquencies, defaults, and foreclosures. Too often lenders ignored FHA requirements to get a loan approved. Borrowers were sold unsustainable mortgages, sometimes unsuspectingly and sometimes with their full knowledge, which encouraged widespread indifference to the ability of many consumers to repay their loans. Some lenders thought they could make money on a loan even if the consumer could not pay back that loan, by either banking on rising housing prices or passing along the mortgage into the secondary market.

Adding to this problem was a100 percent insurance guarantee by FHA, which created no real financial exposure to these losses on the part of the lender and in some cases, no real incentive to comply with the requirements of participation. The practices of many lenders were not just the result of poor procedures but involved real infractions of good business stewardship and proper behavior when participating in the FHA program. A failure by FHA to create a strong and meaningful oversight atmosphere creates an environment that virtually invites the abuses we have seen in our lender reviews. Quite simply, lenders are responsible for complying with all applicable HUD regulations and in turn are protected against default by FHA's insurance program for doing so. To provide some context, mortgage fraud is second only to health care fraud on DOJ's list of investigative and prosecution priorities.

Indeed, our reviews have shown high percentages of loans containing significant deficiencies, loans that clearly should not have been underwritten. Our reviews look for major noncompliance and a failure to follow the rules that have long been established. We are not looking at close-call interpretations of underwriting but wholesale abandonment of the core requirements that leads to huge default and claim rates for FHA-insured mortgages.

By way of example, my office is currently reviewing one lender's claims to FHA using a statistically representative sample of all claims it made in a given period. The statistical sample pool was 85 loans. While these results are preliminary, 91 percent of those loans had significant deficiencies, 77 of 85 loans. Of those loans with significant deficiencies, 87 percent, or 67 loans, had material, incurable violations of HUD underwriting requirements and standards. These violations were essentially incurable by the lender and exposed the FHA insurance fund to an unacceptable level of risk and claims that it did not agree to take on under the insurance program.

In another ongoing example, we conducted a review of a statistically representative sample of claims at another lender. Again, the statistical sample pool was 85 loans. Again citing preliminary results, the percentage of those loans that had significant deficiencies was 100 percent. Of those 85 loans, 78 loans (92 percent) had material, incurable violations of HUD underwriting requirements and standards. We expanded our review to defaults for this lender using a statistically representative sample, which resulted in a sample pool of 110 loans. Our preliminary review found that every one of those loans – 110 of 110 (100 percent) – had significant deficiencies. Of those 110 loans, 95 (86 percent) had material, incurable violations of HUD underwriting requirements and standards that also exposed the FHA insurance fund to an unacceptable level of risk and claims that it did not agree to take on under the insurance program.

To be clear, we are not talking about minor deficiencies. These reviews are exposing violations of HUD's underwriting requirements and standards, which constitute substantive material violations. Therefore, the underwriter's certifications to HUD are false, and those loans can form the basis of a False Claims Act case. The types of substantive material violations that we are uncovering amount to violating fundamental requirements of insuring a loan, which include failing to document a borrower's income and employment, failing to evaluate all recurring debt obligations that FHA requires an underwriter to consider, and failing to verify that the borrowers possess the necessary funds to close the loan.

It is OIG's contention that if lenders follow a well-established quality control plan, exercise due diligence and good industry practices, follow required procedures, and submit documented conforming loans based on a reasonable good faith determination of a consumer's ability to repay the loan, their lending behavior does not have to be unduly constrained nor should they overly restrict making responsible loans.

Inventory of Foreclosed-Upon Single-Family Properties

In prior years, we have reported on various concerns relating to HUD's procurement and contract management, including HUD's IT infrastructure contracts and HUD's transition to the third generation of its management and marketing contracts that are used to manage and dispose of its extensive inventory of foreclosed-upon single-family properties, known as real estate-owned (REO) properties. HUD continues to be challenged by its overreliance on contractors in general and its ability to allocate sufficient resources to adequately oversee its contractor workforce. Since taking this position, I have made it a priority to take a closer look at the Department's procurement and contract management processes to ensure that waste, fraud, or mismanagement can be identified at its earliest occasion.

HUD's inventory of REO properties had increased dramatically from about 45,700 properties in March 2010 to nearly 69,000 at the end of March 2011. The inventory declined after HUD restructured its management and marketing contracts and as of January 2013, stood at about 39,000. While the decline from the historically high levels of 2 years ago is a positive trend, the percentage loss on the sale of these properties remains high but has begun to decline. Still, during FY 2012, losses averaged about 62 percent of HUD's acquisition cost. In contrast, HUD's average loss during 2007 was about 40 percent. HUD's oversight of these management and marketing contractors will be critical to ensure that returns on property sales are maximized, thereby reducing further losses to the FHA insurance fund. During FY 2012 alone, FHA's losses on REO property sales exceeded $9.2 billion.

We recently completed an audit of HUD's oversight of its REO Management and Marketing program to determine whether HUD's policies and procedures provided for efficient and effective oversight of asset managers and field service managers under the program. We determined that HUD did not have adequate procedures in place to ensure consistent and adequate enforcement of asset and field service manager contracts. Specifically, (1) list prices were not always reduced according to the marketing plans, (2) bids were approved that did not meet HUD's flexible threshold, (3) bids were rejected that met the marketing plan thresholds, (4) bids that met applicable thresholds were not always counteroffered or forwarded to the government technical representative for approval, and (5) properties were not assigned to field service managers based on performance even when HUD identified performance issues.

Financial Management Systems

Since FY 1991, OIG has annually reported on the Department's lack of an integrated financial management system, including the need to enhance FHA's management controls over its portfolio of integrated insurance and financial systems. We continue to report that HUD's financial management systems have not substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996, which encourages agencies to have systems that generate timely, accurate, and useful information with which to make informed decisions and to ensure accountability on an ongoing basis. This situation could negatively impact HUD's ability to perform required financial management functions and efficiently manage financial operations of the agency, notably FHA, which could translate to lost opportunities for achieving mission goals and improving mission performance.

In August 2009, FHA completed the Information Technology Strategy and Improvement Plan, which identified FHA's priorities for IT transformation. The plan identified 25 initiatives to address specific FHA lines of business needs. Initiatives were prioritized, with the top five being single-family related.

To date, FHA has completed a few of the goals but not all due to a lack of funding. FHA is working on acquiring risk management tools but has only made substantive progress with its initial objective. During our upcoming audit of FHA's FY 2013 financial statements, we will be reviewing FHA's progress in implementing this plan.

The plan also called for FHA to create a program management office to facilitate coordination and communication, track and report progress, provide support to managers, and support organizational change management activities. This office was put into place almost immediately after the funding became available and is being led by a long-term IT staffer.

Since FY 2009, the FHA Transformation Initiative's focus has been on improving its counterparty management by automating the certification processes and acquiring risk management tools to monitor lender activity. In conjunction with these development activities, FHA has procured the IT infrastructure needed for its planned improvements to multifamily underwriting and single-family insurance program support.

Our biggest remaining IT concern is FHA's ability to replace the antiquated infrastructure on which many FHA single-family applications reside in a timely manner. For example, FHA's general ledger is an Oracle system, which has to interface with multiple older COBOL systems. None of the older legacy COBOL systems have received sufficient funding to be replaced, yet they are expensive to maintain. Due to a lack of funding, interfaces and the related systems are still in place. While there may have been some programming changes, we understand that these were basically patches or temporary fixes to implement specific policy changes.

Overall, it appears that funding constraints have reduced the FHA Information System Transformation project to a continuation of high-level planning without a defined timetable to complete the new application systems and to phase out and deactivate the current outdated systems.

These delays bring about another concern: the ability to maintain the antiquated infrastructure on which some of the HUD and FHA applications reside while the Transformation Initiative is underway. Workloads have dramatically increased and are processing on systems that are 15 to 30 years old. These legacy systems must be maintained to effectively support the current market conditions and volume of activity. However, the use of aging hardware and software can result in poor performance and high maintenance costs. If the IT infrastructure is not modernized in a timely manner, it will become increasingly difficult and expensive to maintain operations, make legislatively required system modifications, and maintain interfaces to other IT systems.

Recent OIG Investigative and Audit Results

As mentioned earlier, HUD OIG conducts criminal investigations involving allegations of fraud against HUD's programs, including theft, embezzlement, and false statements by program participants and recipients. The investigations may be generated from leads provided by HUD program staff, the mortgage industry, and other sources and may be conducted jointly with Federal, State, and local law enforcement agencies. Our long-term investigative experience in the area of mortgage fraud schemes has given us proficiency and extensive knowledge to address these issues. Many "traditional" fraud schemes continue to affect FHA, such as appraisal fraud, identity theft, loan origination fraud, rescue and foreclosure fraud, and fraud in the HECM program.

The following represent some examples of recent investigations:

- A former mortgage company loan officer was sentenced to 54 months incarceration and 3 years supervised release and was ordered to pay more than $9.2 million in restitution to FHA. He conspired with others to create and submit false and fraudulent FHA mortgage loan applications and accompanying documents to a lender on behalf of unqualified borrowers. He created false pay stubs, Federal tax forms, verification of employment forms, explanation letters, and other documents to ensure that otherwise unqualified borrowers could obtain FHA-insured loans. He enticed borrowers to obtain an FHA mortgage by paying them an incentive of up to $20,000 per loan. More than 75 FHA loans were approved using this false information with more than 31 claims identified. The loss to FHA was estimated at $6.5 million. The mortgage company was terminated as an FHA-approved lender, and the loan officer and others were suspended pending debarment action. Our investigation is continuing.

- A former senior vice president and loan officer, a former senior vice president of residential lending, a former underwriter, and a former loan processor pled guilty to conspiracy to submit false statements in loan applications and submitting false statements in loan applications to FHA. The defendants were involved in originating and approving FHA-insured loans and conventional loans that contained fraudulent information. The case involved approximately 1,900 FHA loans. To date, FHA has incurred losses in excess of $36 million after paying claims on and disposing of 234 foreclosed-upon properties. An additional 393 loans, with an unpaid balance in excess of $92 million, have been identified as delinquent or in various stages of the foreclosure process. The bank was closed by the Federal Deposit Insurance Corporation and is no longer in business. The above-noted defendants have been recommended for suspension and debarment action, and our investigation continues.

- Two former principals of a HUD-approved mortgage company pled guilty to one count of racketeering following their indictment in June 2011. The defendants were involved in a complex scheme to defraud FHA through a series of false statements on at least 65 FHA loans totaling in excess of $10 million. The fraudulent acts included the use of straw purchasers, phony employers, bogus bank statements and pay stubs, forged college transcripts, counterfeit court documents, and phony downpayment gifts. Additionally, the defendants profited from the scheme by recording junior mortgages that were payable to business entities or associates from the loan proceeds. The mortgage company's FHA approval was terminated, and the company's principals were suspended pending their debarment.

OIG's Joint Civil Fraud Division conducts reviews of FHA-approved lenders. The reviews continue to disclose serious deficiencies in the originating and underwriting of FHA mortgages. As noted earlier, many of these reviews were conducted in support of our efforts to recover losses. These reviews and our audit work focus on areas in which HUD can improve its oversight and management of its single-family mortgage insurance programs. For example, as noted earlier, OIG reviewed the foreclosure practices for five of the largest FHA mortgage servicers (Ally Financial, Incorporated; Bank of America; CitiMortgage; JPMorgan Chase; and Wells Fargo Bank) due to reported allegations made in the fall of 2010 that national mortgage servicing lenders were engaged in widespread questionable foreclosure practices involving the use of foreclosure "mills" and a practice known as "robosigning."

In September 2012, we summarized the results of the five reviews, which were used by DOJ and 49 State attorneys general to negotiate a settlement with the five lenders totaling $25 billion. The Federal settlement payment amount of more than $684 million would be used for (1) losses incurred to FHA's capital reserve account and the Veterans Housing Benefit Program Fund or as otherwise directed by the U.S. Department of Veterans Affairs and the U.S. Department of Agriculture's Rural Housing Service and (2) the resolution of *qui tam* actions

As result of this work, OIG recommended that HUD (1) determine the changes needed to FHA's servicing and foreclosure policies based on the consent judgments and ensure that the servicers incorporate the necessary changes into their procedures for servicing FHA-insured loans; (2) ensure that the servicers establish or implement adequate procedures and controls to address the control deficiencies cited in the five issued memorandums, including but not limited to the withholding of claims for insurance benefits and the retention of appropriate legal documentation supporting the appropriateness of the foreclosure for all FHA-insured properties for the life of the loans; and (3) pursue appropriate administrative sanctions against attorneys who may have violated professional obligations related to the foreclosure of FHA-insured properties.

Finally, the Department continues to face challenges in ensuring that its single-family programs benefit eligible participants and do not pay improper claims. In a recent audit of FHA's Preforeclosure Sale Program, OIG identified that, based on a statistical projection FHA paid an estimated $1.06 billion in claims for 11,693 preforeclosure (short) sales that did not meet the criteria for participation in the program. This condition occurred because HUD did not have adequate controls to enforce the program requirements and requirements were not well written. Specifically, FHA relied entirely on the lenders in approving borrowers for the program and did not provide lenders with detailed instructions for reviewing borrower assets. As a result, the FHA insurance fund may have taken unnecessary losses while borrowers, who may otherwise have been able to sustain their obligations, were inappropriately relieved of their debt using FHA insurance fund reserves. FHA has agreed that existing program policy and lender execution against that policy are inconsistent. In response to our recommendations to improve alignment and ensure that the long-term interest of the FHA insurance fund are met, FHA is working toward (1) introducing a streamlined program approval policy based on loan characteristics and a borrower credit profile and (2) specifying income documentation requirements for the income deficit test that must be met for borrowers who do not meet the streamlined requirements.

Conclusion

The Department's role has greatly increased, while staffing has decreased, over the last decade as it has had to deal with unanticipated disasters and economic crises in addition to its other missions, which have increased its visibility and reaffirmed its vital role in providing services that impact the lives of our citizens. The Department can do more to address the internal control and program weaknesses in FHA. My office is strongly committed to working with the Department and Congress to ensure that these important programs operate efficiently and effectively and as intended for the benefit of the American taxpayers now and into the future. I look forward to working with the Department and this Subcommittee to accomplish some of these goals.