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BEFORE THE
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Good morning Chairman Ney, Ranking Member Waters, and distinguished Members of the Subcommittee on Housing and Community Opportunity. On behalf of Secretary Jackson and the Department, thank you for this opportunity to testify on mortgage fraud and its impact. Mortgage fraud and predatory practices adversely affect both homebuyers and the real estate finance industry. Inevitably the costs resulting from the actions of a small number of disreputable individuals are borne in part by homebuyers and mortgage lenders, as well as by taxpayers. Today I would like to provide you with an overview of HUD's initiatives and describe what HUD, particularly the Federal Housing Administration (FHA), is currently doing to address this problem.

Predatory practices can take many forms, from making a mortgage loan to an individual who does not have the ability to pay, to property flipping. Lenders who use these tactics often target our most vulnerable populations. First time homebuyers in particular are not familiar with the mortgage origination process. Susceptible borrowers are steered toward over-priced service providers or encounter high-pressure salespeople.

One common predatory practice is to impose on a borrower excessive fees and points, with the promise that the borrower can refinance to a lower rate a few months after origination. The end result is that the borrower pays origination fees twice, in order to obtain mortgage terms they should have received with their initial mortgage loan.

Predatory loans harm borrowers by making it difficult or impossible for them to keep up with payments. If they miss their payments, they risk losing their home, their credit standing and their initial investment. Even if they remain current in their mortgage, a homebuyer may owe more than their home is worth, making resale of their home impossible.

Predatory lending can rise to the level of criminal activity and constitute mortgage fraud. Mortgage fraud is a criminal activity, knowingly undertaken by individuals intent on profiting at the expense of others. Actions include deliberate manipulation of property valuations; falsification of borrower financial information; forgery of licenses; certifications and titles; and misrepresentation of property ownership and conditions.

Fraud is often only discovered when the borrower defaults on the mortgage, and the lender, investor, or insurer – such as FHA -performs a quality control review on the loan. By statute, FHA refers all potential fraud to HUD's Office of Inspector General (OIG).

FHA has the authority to monitor lenders for program compliance. During the last four years, FHA has completed 3,623 lender monitoring reviews. As a result, FHA made 1,345 referrals to the OIG to investigate findings of possible fraud during this period.

Borrowers are not the only victims of mortgage fraud and predatory practices. Within the FHA mortgage insurance program, lenders are financially liable for the portion of the costs associated with delinquency and foreclosure that HUD will not reimburse (usually higher-than-customary servicing expenses and a portion of the foreclosure costs). Lenders whose employees violate FHA guidelines may also be required to indemnify loans (thereby reimbursing HUD for all losses associated with the loan) if the lender failed to use proper, early due diligence and effective control measures to detect fraud associated with a loan. In addition, a lender's FHA default and claim rate calculated by HUD will be negatively impacted due to fraudulent loans, which could affect the lender's ability to continue to do business with FHA as an FHA approved lender. Lenders who purchase fraudulently originated loans from other lenders may incur significant costs as well. To avoid these risks, credible lenders must incur expenses to strengthen internal control processes.

Concern over lawsuits is certainly a motivational factor for lenders to aggressively address risk associated with mortgage fraud. Civil actions resulting from mortgage fraud can be expensive. The most effective approach for lenders to mitigate such risk is to demonstrate that effective internal controls and due diligence procedures are in place to detect fraud, that actions are swiftly taken to terminate relationships with the perpetrators, and to ensure that the victims of fraud are appropriately compensated.

FHA's actions to combat mortgage fraud and predatory practices

FHA has made significant efforts through consumer education, enforcement actions and regulatory reforms to combat abusive and deceptive practices. Before I discuss the full range of these efforts across all FHA's insurance programs, I would like to describe FHA's mortgage insurance activity to the Subcommittee, in order to place our efforts in context. FHA insures mortgages for homebuyers who may not qualify for conventional mortgage loans. Our typical borrower is a young, first-time homebuyer, often a minority household. For the first 11 months of FY 2004, FHA insured 578,774 home purchase mortgages. Of these, 72 percent were to first-time homebuyers; 33 percent of those were to minority first-time homebuyers. FHA has 15 percent of the home market share, but 27 percent of the market for low-income homebuyers.

HUD believes that our first line of protection is an informed consumer. Housing counseling has proven to be an extremely important activity to educate consumers on how to avoid abusive practices. Housing counseling agencies help educate borrowers, so they have the financial literacy they need to protect themselves. Counselors assist individuals with making intelligent decisions, helping unwary borrowers avoid inflated appraisals, unreasonably high interest rates, unaffordable repayment terms, and other conditions that can result in a loss of equity, increased debt, default, and even foreclosure.

In FY 2004, HUD awarded $36 million in grants to HUD-approved housing counseling agencies. Based on actual activity and outcomes from past years, HUD projects these grants will assist more than 700,000 people to either become first-time homeowners, or remain homeowners after their purchase. The grants were awarded to 19 national and regional organizations and 342 state and local housing counseling agencies. Additionally, HUD will award $7.75 million to standardize and improve the quality of counseling provided by HUD-approved housing counseling agencies.

We know that housing counseling works. Families who receive counseling are better able to select the best mortgage for their needs and better able to manage their finances so they can remain in their homes. Housing counselors help to heighten the awareness of potential homeowners of the dangers of mortgage fraud and predatory practices.

FHA is improving the way citizens find HUD approved housing counseling agencies. Currently, in order to find a local HUD approved housing counseling agency, an individual calls a toll free number and interacts with an automated computer system. By the end of fiscal year 2005, the computer will be replaced by live operators.

Final Rules

The Department has developed new requirements specifically targeting predatory practices to protect all FHA borrowers and set an example for the rest of the housing industry. In particular, there are several new, more stringent procedures for participating in FHA insured programs that have been implemented in eight Final Rules. They include:

- A Lender Accountability Rule that clearly establishes lender responsibilities associated with the quality of property appraisals, effective August 19, 2004.

- A Rule establishing a Fee Panel Inspector Roster. This Rule provides criteria for placement of new construction home inspectors on the roster and established procedures for removal from the roster. This rule became effective April 9, 2004.

- An Anti-Flipping Rule prohibiting FHA insurance on a property resold within 90 days of the previous sale, and also prohibiting sale of a property by anyone other than the owner of record. This rule became effective in June 2003.

- An Appraiser Qualifications Rule for Placement on FHA Single Family Appraiser Roster, establishing stronger professional credentials for FHA-approved appraisers. This rule became effective in June 2003.

- A rule for HUD's roster of 203(k) consultants, to ensure the consultants meet HUD requirements. This rule became effective in September 2002.

- A rule allowing Electronic Submission of Audited Financial Statements. This rule enables HUD to identify and remove noncompliant lenders more quickly. This rule became effective in September 2002.

- A rule establishing Placement and Removal Procedures for HUD's Nonprofit Organization Roster, better insuring that nonprofits participating in FHA programs meet HUD requirements. This rule became effective in July 2002.

- An Interim rule that ensure that seniors who refinanced their FHA insure reverse equity mortgage were not subjected to mortgage churning by the lender. Mortgage churning benefits the lender by refinancing the original mortgage with no benefit to the borrower. This rule became effective in April 2004.

Proposed rules:

- A proposed rule limiting nonprofit organization participation in FHA Single Family activities. This rule proposes ways to reduce defaults by nonprofits and create more reasonable conditions for ensuring qualified nonprofit participation in FHA programs. It would limit nonprofits to ownership of 10 FHA insured loans at one time, restricts nonprofits to single unit properties, and requires the nonprofit to have its 501 (c3) status for two years. This proposed rule was published April 2004.

- A proposed rule revising FHA's Credit Watch program to capture underwriting lenders as well as originators, and preventing a lender from opening a new branch within the area covered by the proposed termination. This proposed rule was published in April 2003.

- A proposed rule published on April 14, 2004, which would establish a procedure for HUD to impose new penalties on lenders that fail to engage in loss mitigation. These penalties would amount to three times the amount of a foreclosure claim submitted by a lender on a foreclosure claim. This powerful sanction will be applied to any lender who consistently falls in the on the bottom tier of FHA's "Tier Ranking System" for servicing lenders, and where specific failure to engage in loss mitigation prior to foreclosure is detected.

Program Improvements:

FHA has also put in place a series of policy directives designed to elevate industry standards for deterring mortgage fraud and predatory lending while also protecting the Government from incurring excessive risk. These include:

- Deployment of the "TOTAL Scorecard", an automated risk scoring algorithm that interfaces with an automated underwriting system. TOTAL allows FHA to better gauge risk, particularly among marginally qualified borrowers, and helps FHA to understand and manage credit risk of mortgages entering its portfolio. With the TOTAL Scorecard, FHA can expand the scope of borrower participation while more precisely managing risk.

- Update of FHA's Mortgage Credit Underwriting Handbook, which clarified and strengthened those policy areas that may have previously been open to varying interpretations by lenders.

- Issuance of new guidance related to new construction transactions. Most particularly, FHA requirements were tightened to address a predatory practice of underwriting a mortgage based upon tax assessments for an unimproved property. Lenders must now ensure that borrower income and escrows will support tax requirements for the *improved* property on new construction financing. This same guidance established tighter underwriting requirements for "mortgage buy-downs", an approach often abused by predatory lenders in order to improperly qualify borrowers for loans the borrowers cannot afford.

- Issuance of new guidance on Social Security Number verification. This initiative reduces the likelihood that a borrower on a FHA mortgage is using a false social security number or otherwise committing identity theft and fraud in connection with obtaining an FHA-insured mortgage.

- Implementation of an automated risk-based assessment, following mortgage insurance endorsement, to improve FHA's ability to identify, monitor and oversee loan compliance.

- Implementation of Appraiser Watch, a risk based monitoring of appraisers. This change resulted in a higher number of appraisers being removed from the FHA Appraiser Roster, because they prepared appraisals that did not meet FHA's requirements.

- In Fiscal Year 2004, FHA established a national training program for lenders and appraisers. Over 1,000 lenders have participated in this training program. This training provided comprehensive information in participating in FHA single-family mortgage programs.

Monitoring and Enforcement

In addition to establishing more stringent procedures for participating in FHA insured programs, the Department is taking aggressive action concerning business partners that demonstrate poor performance and abusive practices.

FHA has created the Credit Watch Program, which tracks quarterly the default rates for the 25,000 lender offices that originate FHA loans, and enables HUD to terminate those lender branches where the default rate significantly exceeds that of the local jurisdiction. Credit Watch protects the integrity of the FHA insurance funds and sanctions those lenders who demonstrate imprudent or possible abusive lending practices. The default rates of these lenders are published on the Web and thereby serve as a source of information by which other lenders and interested parties can judge a lender's performance. Originally FHA set the standard for a "high default rate" at three times the rate for the local market. Subsequently, FHA issued Mortgagee Letter 2002-20 in September 2002, starting the process of gradually lowering that standard over a year. Since September 2003, FHA terminates lenders with early default rates exceeding twice the local market rate, unless there is a good explanation.

Since Credit Watch started in May 1999, FHA has terminated 261 lender branches and currently have another 14 branches under review. The industry supports Credit Watch: we sanction the worst performers, and create a level playing field for those who follow the rules.

FHA also produces Neighborhood Watch, a web-based software application, for HUD oversight of lenders and lender self-monitoring. Neighborhood Watch compliments the Credit Watch Termination initiative by providing FHA approved lenders with statistical views of their performance. As a self-policing tool it has enabled lenders to monitor their performance in comparison to other lenders, to take corrective actions within their own organizations, and/or to sever relationships with poorly-performing business partners. Neighborhood Watch is also used by community groups to monitor local lenders, and by HUD's OIG to identify possible lenders for audit or investigation. Neighborhood Watch is available at: https://entp.hud.gov/sfnw/public/.

When FHA staff finds evidence of widespread abuse of HUD's program requirements, lenders are referred to the Mortgagee Review Board (MRB) for action. I chair the MRB and other senior HUD officials serve on the Board. Board cases generally involve only the most serious findings. The MRB is authorized to impose a range of administrative sanctions from a letter of reprimand to withdrawal of a Mortgagee's FHA approval. The MRB may also impose civil money penalties. FHA monitors the activities of lenders down to the branch level. Based on these reviews, over the past four years, the MRB took action against 174 lenders, withdrew FHA approval of 44 of them, and assessed $8.83 million in civil money penalties. Also, 11,419 loan indemnification agreements were executed for a potential total savings of about $266 million. When FHA finds loans that are improperly originated or underwritten, we require indemnification: if the loan defaults, the lender pays, not the FHA Mutual Mortgage Insurance Fund. FHA made over 1,345 referrals to the OIG for further investigations. FHA has proposed debarment of 1,995 individuals and entities from participating in FHA's Single-Family Programs.

Appraiser Watch

As I previously noted, FHA has also created a new risk management tool to target appraisers for review, known as "Appraiser Watch." Appraiser Watch uses traditional risk factors - such as loan volume, loan performance, and loan type - to compare appraisers across peer groups and identify appraisers for review. With Appraiser Watch, FHA can better identify appraisers who either knowingly or unintentionally put homeowners at risk of losing their homes to foreclosure because of inflated valuations and sometimes the poor condition of the property.

Appraiser Watch is a major improvement over the appraiser monitoring system we inherited from the previous administration. Under the previous appraiser monitoring methodology, used from 1999-2001, 30,000 appraisals were field reviewed through contract at a cost of $46 million, yet only 33 appraisers were removed from the FHA Appraiser Roster.

In FY 2002, when FHA began testing a new risk-based targeting methodology, which ultimately led to the creation of Appraiser Watch, directed by FHA, a smaller number of higher risk appraisals, 1,868 appraisals (representing 708 appraisers) were field reviewed at a cost of $300,000 and 97 appraisers were removed from the FHA Appraiser Roster.

In FY 2003, under the Appraiser Watch methodology, 1,420 appraisals (representing 767 appraisers) were field reviewed and 132 appraisers were removed from the FHA Appraiser Roster at a cost of approximately $311,000.

For the first 3 quarters of FY 2004, 1,072 appraisals were field reviewed (representing 340 appraisers), and 96 appraisers were removed, at a cost of approximately $245,000.

These removals represent less than 1 percent of the total number of appraisers on the FHA Roster, but we have the industry's attention that we're serious about monitoring appraisals closely.

Inter-Agency Cooperation

HUD works closely with state and local governments to carry out enforcement actions against business partners engaged in predatory practices. On a national level, HUD's OIG continues to work closely with law enforcement in many states, notably in New York, New Jersey, Pennsylvania, Illinois and Arizona, to target unscrupulous lenders and better combat abusive lending practices. In many areas HUD is working with coalitions of community groups to provide relief to FHA insured borrowers who have been victimized by predatory practices.

HUD also works closely with the Department of Justice, federal financial regulators and the Federal Trade Commission to distinguish between predatory practices of some lenders and others whose practices are fairly serving the mortgage credit needs of those not qualified for prime loans.

Public Awareness

FHA is committed to increasing awareness in the public about predatory practices. FHA has developed literature about predatory lending and distributes this information at homeownership fairs and other public forums. HUD's website also includes information on the subject. Our website was just recently enhanced to allow easier access to this information to the general public. A link on HUD's primary page (www.hud.gov), named "Avoid Predatory Lenders" takes you to a page on "Predatory Lending," which contains information on how to recognize predatory lending and what to do about it. This page also contains links to additional information for each state, prepared by local organizations to address the problems most prevalent in their areas. I recently was interviewed on CNN regarding predatory practices, and among other indicators of public interest in this subject, hits on our web page soared the following day.

In addition, HUD has partnered with other organizations in public education campaigns about predatory lending. In early 2005, HUD will launch a national advertising campaign to warn against the dangers of predatory practices. The $1 million campaign consists of print, radio, and television ads. The ads are being produced under a contract with the National Fair Housing Alliance and the Ad Council.

HUD is also a member of the Interagency Task Force on Fair Lending. HUD worked with the task force in drafting a new brochure that alerts consumers to potential borrower pitfalls, including high cost loans and provides tips for getting the best financial deal possible.

Through HUD-sponsored Homeownership Fairs, participation in community events, and industry-sponsored forums, the Department is shining a bright light on unsavory mortgage lending practices.

Loss Mitigation

FHA also addresses predatory practices through our Loss Mitigation Program, which is often able to help a victim of such practices who has defaulted on an FHA-insured mortgage and faces possible foreclosure. Under this program, lenders have options that may help homeowners stay in their homes or may mitigate the financial consequences of the default if the homeowner does not have the resources to make that possible. FHA pays loss mitigation insurance claims to help qualified borrowers reinstate their mortgage. FHA regulations require that lenders explore all available loss mitigation options prior to proceeding to foreclosure. The success of this program is clear. In Fiscal Year 2004, HUD helped more than 80,000 families avoid foreclosure, and the number of loss mitigation cases resolved by the borrower retaining their home through loss mitigation exceeded the number of cases resolved through foreclosure. In addition to helping these borrowers, the Department saved more than $1 billion in foreclosure claim expenses. As mentioned above, the Department is strengthening the enforcement of this requirement by imposing treble damages against lenders that fail to offer loss mitigation opportunities as appropriate.

Conclusion

I hope this discussion of our efforts and accomplishments has made clear that the Administration and the Department are aggressively policing its participants and imposing significant sanctions on business partners found to be violating procedures or otherwise engaged in abusive or deceptive behavior. In doing do, HUD is establishing standards and industry approaches that we hope will be adopted in the conventional market as well. The most effective means to reduce the adverse impact of predatory practices and mortgage fraud is to root out the culprits, and create an environment in the mortgage industry which fosters integrity and concern for the homebuyer. The Administration and the Department remain firmly committed to protecting consumers and all program participants against predatory practices and mortgage fraud.

This concludes my statement, Mr. Chairman. I thank the Committee for the opportunity to meet with you today to discuss this important issue.