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The Role of the Housing and Urban Development Department (HUD)

Introduction

This chapter will set out the role of the Housing and Urban Development Department (HUD). It is worth noting that this was a large and rambling government department, which was never well managed and was notoriously involved in corruption in the various housing programs it managed, involving public funds. The Office of the Inspector General provided a large number of reports over the years, detailing HUD fraud and incompetence; such reports will not be described here, as it is HUD's responsibilities for home ownership in general and for the FHA in particular, which illuminate the affordable housing program.

Established as a Cabinet Department by President Lyndon Johnson in 1965, HUD rapidly acquired a wide range of responsibilities for many and varied housing programs, including public housing, voucher assistance for rented accommodation, housing for the elderly, those with disabilities, persons with AIDs, community development block grants, neighborhood stabilization programs (for those hard-hit by foreclosures and delinquencies) and housing for the homeless, to name but a few. Given the number and complexity of these housing programs, it is perhaps small wonder that HUD was subject to frequent criticisms by the GAO and by its own Inspector General on the grounds of lack of proper management and oversight of its many responsibilities and the failures of its accounting systems.

In addition to the above responsibilities, HUD encompassed other important appointments, including the Federal Housing Commissioner, heading up the Federal Housing Administration; and the Director, Office of the Federal Housing Enterprise Oversight (OFHEO), set up under the Housing and Community Development Act, 1992 to ensure that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are adequately capitalized and operating in a safe and sound manner. Other positions include the President of the Government National Mortgage Association (Ginnie Mae), which provides a secondary market for FHA loans, and the Office of the Inspector General, responsible for conducting and supervising audits and carrying out investigations.

The role of HUD during the Clinton administration

Preparing the ground

It was to HUD that President Clinton turned to implement his program to extend home ownership to low- and moderate-income families. He appointed as Secretary, Henry Cisneros, four times Mayor of Clinton's home town of San Antonio, Texas and only the second Hispanic to hold that office. Cisneros had already decided not to seek a further term and became one of Clinton's advisers for his successful Presidential campaign. A strong supporter of the Hispanic community with a commitment to advancing its share of economic life, Cisneros set about the work enthusiastically.

His first challenge once appointed was to fend off the movement in Capital Hill to abolish HUD altogether, following the 1994 Congressional election, when the Republicans won a majority in the House. His prepared reports in defense emphasized the losses that many American families would face if HUD was abolished, and HUD's local offices argued that the elimination of the department would vastly expand America's underclass, leaving many families, including those with children, homeless.

The focus of HUD's work shifted to expanding home ownership, partly through necessity as a result of changes introduced by the Budget. HUD and the FHA were agencies of the federal government and were funded through the Budget. But "in 1990, as part of a new, multi-year Budget agreement, the Congress and the President adopted new procedures for deficit control. These procedures, embodied in the Budget Enforcement Act of 1990, established statutory limits on discretionary spending and a deficit-neutral pay-as-you-go requirement for new mandatory spending and tax legislation."¹ This coupled with the Federal Credit Reform Act, 1990, and the Omnibus Budget Reconciliation Act, 1990, restricted spending on the FHA, for if the expected premiums were not enough to cover losses, these would have to be regarded as a Budget item, and the latter Act required the FHA to establish a reserve fund and set its premiums at a sufficient level to ensure actuarial soundness.

These restrictions did not, however, prevent President Clinton from cutting the mortgage insurance rates three times between 1993 and 1997. This reduced the mortgage insurance premium from 2% to 1.75%, with the cuts taken together, along with savings passed on to home buyers because the increased efficiency of the FHA would save them \$1,200 on the closing costs of the average FHA mortgage of \$85,000.² The reduction announced on June 12, 1997 accounted for \$200 of that saving. This was another attempt to reduce the barriers to home ownership, namely the high closing costs. To qualify for that reduction, prospective first-time home buyers had to successfully complete the 16-hour Homebuyer Education and Learning Program; FHA

statistics showed that those who completed this course were better prepared for home ownership and were less likely to default.³ But this also turned out to be a mistake, as the fund ran into difficulties and the premiums had to be raised again in the years to come. In line with the Budget restrictions, it was supposed to be funded by cost-saving management improvements at the FHA. All of this meant that the possibility of providing affordable housing through government funding was no longer open to HUD. Other ways would have to be found for the realization of the American dream. Under President Clinton's direction, Secretary Cisneros began to work out an alternative.

The partnership program

During 1994, Secretary Henry Cisneros conducted meetings with the leaders of major national organizations from within the housing industry with a view to establishing a national home ownership partnership. All agreed to set up working groups to develop various themes, including the availability of financing and opening markets and targeting underserved populations. The entire strategy consisted of 100 actions to be carried out through a national partnership and a series of State and local partnerships, designed to generate up to 8 million additional home owners by the end of 2000.

The key actions in this document to which so many organizations agreed are as follows:

Action 34. Reduce Down-Payment and Mortgage Costs.

Strategy: The Partnership should support initiatives to reduce down-payment requirements, to encourage savings for down payments by first-time home buyers, and to reform the basic contract between borrowers and lenders to reduce interest costs.

In addition, the amount of money necessary for down payment continues to vary greatly from lender to lender based on many factors, including lender criteria, secondary market investor requirements and mortgage insurer guidelines ... Some lenders are not flexible about other forms of down-payment assistance, such as public subsidies or unsecured loans ... Nevertheless great strides have been made by the *lending community* in recent years to reduce down-payment requirements, particularly for low- and moderate-income home buyers. This trend is encouraging and should be continued with support from the Partnership.

The partnership agreement then notes that the monthly costs associated with owning a home also remain an obstacle for many potential home buyers, of which the interest rate charged is the most important. Interest rates are primarily a function of external economic factors, but they are also affected by the "likelihood of mortgage prepayment by the home buyer, loan assumability by future home buyers, mortgage insurance and loan risk."

Action 35: Home Mortgage Loan-to-Value Flexibility.

Lending institutions, secondary market investors, mortgage insurers and other members of the partnership should work collaboratively to reduce home buyer down-payment requirements ... In 1989 only 7% of home mortgages were made with less than 10% down payment. By August 1994, low down-payment mortgage loans had increased to 29%.

The Strategy then suggests that as “members of the Partnership explore creative means of providing low down-payment financing for potential home buyers, a concerted effort should be made to share success stories and to learn what set of factors generated high loan volume and solid payment histories.”⁴

In essence, then, the plan advocated “financing strategies, fueled by creativity and resources of the public and private sectors, to help home buyers that lack cash to buy a home or income to make the payments.” The result, not surprisingly, was to increase the risks caused by such innovative and flexible features as low down payments and high LTV ratios. This was identified in an analysis provided in the Federal Reserve Bulletin, 1996, which shows conclusively the risk involved in such lending, especially when low credit scores are taken into account.⁵

Handling the risks of affordable housing

As a matter of interest, the authors of the analysis refer to the roundtable discussions held with lenders in preparing the Federal Reserve’s 1993 “Report to Congress on Community Development Lending by Depository Institutions.” The participants generally took the view that the costs of originating and servicing loans made under the affordable home loan programs were greater than those incurred on other housing loans, but that the delinquency and default experience up to that time had not been worse. Statistical analyses undertaken for that report did not find any special relationship between bank profitability and the level of lower-income mortgage-lending activity. The lenders thought that the increased risks of more flexible underwriting could be mitigated in various ways: for some, by drawing on their knowledge of local market conditions and familiarity with borrowers and affordable lending. Lenders of that kind would soon be much smaller players in mortgage provision, when the 1994 Act allowing for inter-state mergers and acquisitions took effect. They also thought that home-buyer education programmes and credit counseling services would screen out higher-risk applicants and prepare home buyers for the responsibilities of home ownership. The authors note that “until recently, most of the available information on the performance of affordable lending programs has been anecdotal.”⁶

It is this lack of hard data, together with little or no statistical analysis in the first half of the 1990s, which no doubt encouraged the politicians to press

for affordable lending, especially against a background in which many believed that home ownership was not open to minorities because of discrimination. They were determined to end that discrimination and open up home ownership to low- and median-income families. In this context it was easier to focus on extending home ownership than to consider the risks which might be associated with affordable lending.

Targets, not risks, were the order of the day

Targets, not risks, dominated housing policy; this was clear from HUD's succession of press releases. Even before the National Homeownership Strategy was fully underway, HUD announced the "sharpest rise in the home ownership rates in at least 30 years, with over 1.4 million new homeowners added in 1995."⁷ The figure rose to 65.1% in the last quarter of 1995, up from 64.2% at the end of 1994, and included increases in the home ownership rate for minorities and for households under the age of 35. This was ascribed to the Clinton Administration's economic policies, lower interest rates and the public-private partnership with the housing industry. The second press release of that year (August 1996) put home ownership at 65.4%, praising lender efforts to assist working families. Secretary Cisneros noted that the market share of first-time buyers rose from about 40% of all home sales in the 1980s to 47% in 1994–1996, as "lenders are discovering that not only does affordable lending make sense, it makes dollars and cents." The Assistant Vice President of Flagstar Bank said that they could help people purchase a home for as little as 3% down, with the remaining 2% and other costs coming from grants, gifts and even lender-financing.

More targets

Andrew Cuomo was appointed HUD Secretary in January 1997 after Henry Cisneros's resignation. A few months later, he announced initiatives to boost home ownership and create 2 million new urban home owners by the year 2000, calling on the National Partners in Homeownership, a coalition of 63 national groups representing the housing industry, lenders, non-profit groups and all sectors of government to work together to achieve the new goals. Other initiatives included Ginnie Mae stimulation of \$1bn in annual mortgage loans to help 15,000 families in inner cities to buy homes each year, and a further \$10m to create new Home Ownership Zones to revitalize inner-city areas. The following year, Cuomo announced that three lenders had agreed to make \$1.39bn available in home mortgages and to spend \$6m on a range of programs to increase home ownership by low- and moderate-income families.⁸

By January 2000, the rate for 1999 had risen to a high of 66.8% for the year as a whole, a higher percentage than at any time in American history,

according to Secretary Cuomo. A total of 70.1m families owned their own homes in 1999, but with rates for the minorities still far behind that of the white population: blacks at 46.7%, Hispanics at 45.5%, and others (Asian Americans, Native Americans and Pacific Islanders) at 54%. President Clinton had more than succeeded in achieving his objective of 8.7 million more home owners in 1999 than when he took office in 1993, and indeed by the third quarter of 2000, the rate was 67.7%.⁹

HUD during the Bush administration

In the second year of his Presidency, George Bush turned to social issues, of which home ownership was one of the priorities. “An ownership society is a compassionate society,” he told the White House Conference on Increasing Minority Ownership in October 2002, having previously made speeches on the need to extend home ownership especially for minorities on a number of occasions throughout that year.¹⁰ His concerns were the familiar ones: the ownership gap between whites and the minorities, with less than 50% of blacks and 50% of Hispanics owning their own homes, compared with over 70% of whites; closing that gap would not only bring stability to communities, it would also reinvigorate the economy. Even with the surge in home ownership during the 1990s, that gap narrowed by only 1.5%.

A Blueprint for the American Dream

In October 2002, the President and Secretary Mel Martinez launched the “Blueprint for the American Dream.” The new goal in the Blueprint was to increase home ownership for minorities by 5.5 million families before the end of the decade. This time, the goal was to be achieved by bringing together 22 public and private partners, including the Mortgage Bankers Association, Mortgage Brokers, Real Estate Brokers, the National Association of Home Builders, the National Association of Hispanic Real Estate Brokers, the National Association of Realtors, the National Credit Union Administrators, Fannie Mae and Freddie Mac, HUD, the US Treasury and others.

The Blueprint Partners identified four key areas on which they would focus in order to increase home ownership:

- Home ownership education and counseling;
- Increasing the supply of affordable homes;
- Providing down payments;
- Improving mortgage lending by increasing funds for affordable loans and redoubling efforts to root-out illegal discrimination.

The context of these proposals differed from that of the 1995 National Partnership. The economy was faltering after the impact of the terrorist attack of 9/11, so part of the emphasis was on the economic benefits that increased home ownership would bring. To accompany the Blueprint, HUD prepared a report on the “Economic Benefits of Minority Homeownership.” It demonstrated that in 2001, the combined housing industry together with the sale of associated consumer goods and home improvement totaled \$1.45 trillion or 14% of GDP. Achieving the goal of increased minority home ownership would add a further \$256 billion over the decade.

Federal help with the costs of home ownership

Once again the down payment was seen as a serious stumbling-block, so President Bush proposed an expansion of the American Dream Down Payment program by increasing this to \$200m per year, which at an average cost of \$5,000 per household would assist 40,000 low-income families with the down payment and closing costs. This required an Act, which was eventually agreed in December 2003. Other sources of assistance would include FHA and VA mortgages, alliances between national non-profit organizations and community groups, employers, local agencies, individual development accounts and innovative mortgage products with very low or zero down payments.

Earlier that year, two other initiatives had taken place. In January, the FHA home mortgage limits had been increased to \$144,336 in low-cost areas and up to \$261,609 in high-cost areas for single-family homes, with similar increases for multi-unit dwellings. HUD announced that this would make FHA loans available for many who had previously been excluded because the limits were too low, and anticipated that it would endorse \$120bn for single-family mortgages for 1.2m in 2002. A \$1,000 cash-back move-in incentive was introduced in July to help with moving costs and repairs, provided the buyer lived in the property for 12 months.¹¹

In the years following the introduction of the Blueprint, fewer announcements were made regarding the increases in minority home ownership. The first came as part of the announcement of Secretary Martinez’s resignation as he decided to pursue an open Senate seat in Florida in September 2003. During that year, minority home ownership increased by 1 million, but President Bush had to wait until December to sign the American Dream Down Payment Act. Alphonso Jackson, the Deputy Secretary, was appointed as Secretary.

Alphonso Jackson takes over at a difficult time

Jackson chose to focus on the increase in sales of existing single-family homes. In July 2004 he announced that these had reached 2.1% in June, to an annual rate of 6.95%, an increase of 17.4% from June 2003, adding that “these numbers

show that housing still leads the way in our rapidly recovering economy.” On July 29, he announced that there were 73.4m home owners, more than at any time in history at 69.2%, with minority home ownership at 51.0%, a net increase of 1.6m since 2002.

In March 2005, sales of new single-family homes rose 9.4% compared with January and 5.2% compared with February 2004. The annual sales rate of 1.226 min February marked the fourth-highest monthly sales rate in the 42-year history of the series. March also recorded a net increase of 2.2m minority home owners, 40% of the goal. For the first time, HUD was able to announce that the 2006 Budget would contain \$200m to fully fund the American Dream Down Payment initiative, which, since it had been signed into law, had helped 3,500 families to purchase their first home. By June 2006, this figure had reached 2.5m, but the overall home ownership rate had dropped slightly to 68.5%. On May 8, 2007, Secretary Jackson announced \$1.8bn for affordable housing and first-time home-ownership programs.¹²

In his prepared remarks for a somewhat ill-timed conference on “Making Home Ownership a Reality,” the Deputy Secretary for Housing, Roy Benardi, referred to the fact that the figure for minority home ownership had reached 3.5m in 2006, but had to focus on the need to educate home owners and modernize the FHA.¹³ This was three days before President Bush’s Rose Garden address, in which he announced plans for the FHA to help an estimated 240,000 families avoid foreclosure by enhancing its refinancing program through FHASecure plan, to allow families with strong credit histories who had been making timely mortgage payments before their loans reset, but were then in default, to qualify for refinancing. The Administration also required Congress to pass the FHA Modernization Act to enable the FHA to maintain liquidity in the mortgage market, but for that, they would have to wait. The time for enthusiastic announcements about increases in home ownership was over. The surging market had begun to falter and the size of the potential problem was, belatedly, beginning to emerge.

HUD’s shortcomings in its oversight role

Numerous press releases give glowing reports of HUD’s achievements in encouraging the growth of home ownership, and in the rescue of those with delinquent mortgages and those facing foreclosure. The department was responsible for oversight of the FHA and for Fannie Mae and Freddie Mac, a matter for subsequent chapters. What the press releases fail to mention is that HUD had frequently shown itself unequal to the many tasks with which it was entrusted. Not all of those are relevant to the issues of this book, as they include oversight of the public housing programs, rental assistance and the many other *ad hoc* initiatives to assist those with limited access to housing, such as the

elderly or disabled, and the replacement of slum properties. The Office of the Inspector General regularly uncovered mismanagement, mis-spending and fraud at every level within HUD, and even found favoritism or cronyism in contract selection at various levels in the organization, even the highest.

HUD was the only Cabinet Department that was ever identified as a “high-risk agency” by the General Accountability Office in 1994, a designation which was only removed in 2001, but was retained in two areas (the rental assistance programs and the FHA Single Family Mortgage Insurance Programs) as late as 2007.¹⁴ It is the latter area which is the main concern here; HUD was responsible for the oversight of every aspect of the mortgages which the FHA insured.

In order to carry out its mission of expanding home ownership, FHA assumes 100% of the risk for the mortgages it insures, especially as it is more likely than private lenders to insure loans for low-income and minority borrowers (according to the GAO in its July 2001 report). The FHA therefore relies on private lenders to determine a borrower’s creditworthiness, and to make and fund loans. It uses private appraisers to assess the value of every property it insures, and relies on contractors to help assess lenders’ compliance with its requirements, monitor the performance of appraisers, and manage and sell the properties it acquires through foreclosure. The GAO points out that without “careful oversight of these lenders, appraisers and contractors, the FHA is vulnerable to mismanagement and fraud.”¹⁵ But in 1997, as part of its 2020 Management Reform Plan, HUD devolved its Single Family Mortgage Insurance Program, including oversight, to four centers. In January 2001, the GAO reported that this was a high-risk area for HUD, and in the intervening months carried out a thorough assessment, including the centers’ monitoring of contractors.

Staff at the centers were supposed to be deployed in sufficient numbers, but were not; they were also supposed to be trained in the new oversight responsibilities, but funds were cut. The result was that the staff were unable and ill-equipped to handle the increased workload, and so expanded their reliance on contractors, contrary to the 2020 Plan, which stated that contractors would only be used to manage and sell the properties acquired through foreclosure. In fact, contractors currently carry out much of the mortgage insurance endorsement activities, including the underwriting quality of the loans insured by the FHA, with staff in the centers being responsible for monitoring contractors. The centers grant FHA-approved lenders direct endorsement authority, which means that they can underwrite loans and determine their eligibility for FHA mortgage insurance without prior approval from HUD. They also oversee contractors who review loan case files by way of a desk audit of the underwriting quality, and endorse or reject loans for FHA mortgages on the basis of these reviews. In addition they are also supposed to conduct on-site evaluations of lenders’ operations (lender reviews) as well as

the contractors who are managing and selling properties acquired as a result of foreclosures.

The GAO concluded that lack of proper oversight was still a major problem, ranging from a failure to review high-risk lenders due to staff inexperience (no background in lender monitoring or credit issues), and rarely conducted on-site reviews of properties assessed by contracted appraisers, because of lack of staff and travel resources; centers did not track the percentage of each contractor's work that had received reviews, nor evaluate their performance.¹⁶ The GAO spelt out what this meant in terms of the size of the potential risks involved. "In the fiscal year 1999, the centers and the contractors endorsed about 1.3m mortgages, totaling \$123.1bn, then a record in dollar terms." The percentage of FHA-insured loans for first-time buyers increased from 70.3% in 1996 to 80.7% in 1999, and for minorities, from 31% in 1996 to 37% in 1999. The processing-time for insurance approvals fell from several weeks to a few days, partly through technology, direct endorsement by lenders and contracting-out. The problems persisted so that in 2005, for example, the Inspector General's semi-annual report to Congress acknowledged that through "their comprehensive audits of poorly performing lenders and effective investigations" they were showing "significant results," as OIG's recommendations have sought monetary recoveries through loan indemnifications exceeding \$133 m, and loss reimbursements of more than £10 m.

But between 2007 and 2009, the familiar problems with HUD's oversight persisted, despite the efforts made by the deputy CFO, James Martin (it was not until 2009 that Robert Ryan was appointed as FHA's Chief Risk Officer). The actions taken in 2007 involved improving the procedures for monitoring the performance of 11,000 private lenders and other underwriters, appraisers and services, responsible for processing and servicing FHA-insured mortgages. The FHA would now seek to administer cost-effective contract services for the management and disposition of HUD-held properties acquired through defaults on FHA mortgages. These processes would be accompanied by sound actuarial reviews and credit subsidy cost models.

The corrective actions undertaken included Neighborhood Watch, Credit Watch and Appraiser Watch programs to weed out poor performers, whose actions would increase the risk of mortgage claims. Two further steps involved developing automated algorithms for targeting highest-risk performers for on-site monitoring, and improving the predictive nature and accuracy of FHA's actuarial and credit subsidy models. The effectiveness of these changes was the subject of constant scrutiny following the introduction of FHA Secure and the plans for the FHA to provide refinancing loans to help families at risk of foreclosure, introduced in 2007. The program was expanded in May 2008 to provide lenders with the added flexibility to refinance and insure more mortgages, including those for borrowers who were late on a few payments and/or received a voluntary mortgage principal write-down from their lenders;

however this was terminated shortly afterwards, since “maintaining the program past the original termination date would have a negative financial impact on the fund.”

As we have seen, this led to a rapid increase in the number of single-family mortgages insured by the FHA, to more than \$180bn at the end of 2008, up from \$59bn in 2007, after the Housing and Economic Recovery Act (HERA) was passed in the summer of 2008. This created a new Hope for Homeowners program to enable FHA to refinance the mortgages of at-risk borrowers, authorizing the FHA to guarantee \$300bn in new loans to help protect an estimated 400,000 borrowers from foreclosure. The figure then available for the first quarter of 2009 showed that the FHA total endorsements had increased from 21% to 70% of the market, which included both home sales and refinances. In early 2009, it was thought that Congress would introduce additional legislation to increase participation. HERA also authorized changes to the FHA’s Home Equity Conversion Mortgage (HECM) to enable more seniors to tap into their home’s equity and obtain higher payouts.

The Inspector General attacks the FHA’s continuing failings

In his presentation to the Appropriations Subcommittee on Transportation, Housing and Urban Development, the Inspector General was at pains to stress the increased likelihood of fraud.¹⁷ He noted that despite the introduction of management improvement schemes and the various proposals for improving FHA’s oversight of all the processes involved in insuring loans, such as those made by James Martin (see above), few of the problems identified since the 1990s had been addressed; and that, too often, OIG recommendations had not been carried out. In the April IOG Report, he pointed out some of the major concerns, once more, including inadequate quality controls; reliance on manual processes; over-dependence on the honesty of program participants to provide accurate and truthful information; and the urgent need to upgrade data systems (the subject of audit work and investigations transmitted to HUD over the years) by deciding on what data should be collected and why.¹⁸

The April IOG Report was followed by an even more devastating report presented to the Committee on Financial Services, Subcommittee on Oversight and Investigations US House of Representatives in June 2009. This document is worthy of careful analysis, as it reveals the extent to which the FHA was exposed to fraud; the failure to act on its many recommendations, not just for a year or two but for a decade or more. Above all, it was and is impossible to make any statements about the nature and quality of the loans insured by the FHA, not just during the surge in such applications from mortgage lenders which began in late 2007, but in previous years of high demand for FHA

insurance during the late 1990s. For the year in question, the FHA Budget for single- and multi-family properties was \$45bn plus mortgage insurance premiums, and its predominance in the mortgage market in 2009 was unparalleled. The program FHA Secure was introduced to refinance existing subprime mortgages and, since it was expanded in May 2008, was terminated in 2009 as the new programs under HERA and HECM came into play.

The first concern expressed by the Inspector was that the weaknesses in FHA's systems and the increases in demand for the FHA program would have collateral effects on the integrity of Ginnie Mae's (Government National Mortgage Association) mortgage-backed securities (MBSs), including the potential for fraud in that program. HUD should also take into account the downstream risks of Ginnie Mae's eventual securitization of HECM Single-Family Loans, since these are the only MBSs to carry the full faith and credit guarantee of the USA. Ginnie Mae had also seen an increase in its market share during 2007 and 2008, with \$150bn in outstanding mortgage-backed securities without the resources to keep pace with the increase. Its struggle to keep up with the FHA was also noted by the industry at the time, as it could also reduce liquidity in the market at a critical time. OIG was concerned because an audit of the Ginnie Mae program revealed that it did not take any steps to check that MBS pools were in fact insured with the FHA within a reasonable period after the pool issuance. The full extent of the problems is best illustrated by the case recorded in the report.

"Two former corporate officers of a Michigan financial company were convicted of defrauding Ginnie Mae by retaining the funds obtained from terminated and/or paid-off loans. The defendants failed to disclose to Ginnie Mae that the loans were terminated, while one of the defendants utilized the funds from paid-off loans to invest in the stock market and make fraudulent monthly payments to Ginnie Mae on the loans that were paid-off to conceal the fraud. *The fraud began during July, 1998 and continued until October, 2007, resulting in a loss of approximately \$20,000,000*".¹⁹ HERA now includes a stiff penalty provision, specifically for fraud against the FHA. This is clearly important, but only if the systems allow for its detection.

The heightened risks to the FHA included its approval of a large number of new lenders, up from 997 at the end of 2007 to 3,300 by the end of 2008, with a further 11,600 lender approvals in the first half of 2009. It was not just a matter of fraudulent or unscrupulous lenders turning to the FHA, but also the fact that the agency had started to serve several new metropolitan areas with which it had had little contact in the past and with the maximum loan limit having been raised to \$729,750. The FHA, due to the loan limit increases, \$729,750, was able to serve new metropolitan areas with which it has had little interaction. With entry into these new markets came new players and unknown hazards, which would potentially lead to much greater losses being sustained by the FHA on defaulted loans; such loans may then become more attractive to

fraudulent lenders, as they would get large payouts from the FHA's insurance scheme.

The report highlights cases of fraud and abuse arising from the lender approval process, but this is clearly not the only problem; the FHA has no means of identifying the key individuals involved in the transaction, such as the originating loan officer, who is responsible for initiating the loan where due diligence should be done (i.e. credit scores, appraisals, etc.). FHA systems should also be able to capture information on the real-estate agent for both the seller and the buyer. These and other changes in the system have long been proposed but never introduced, since the FHA cannot use any of its revenues to invest in new technology. This means that not only can it not keep pace with the industry in the development of technology, but that the agency has been reduced to relying on random, manual processes by contractors to select for review about 2% of lender endorsements, a further reduction of 3%.

Two other significant areas of concern were identified. First the appraiser roster (a separate function), which the FHA was supposed to monitor, ensuring quality control was clearly not fit for purpose. OIG's review found that the roster contained listings of 3,480 appraisers with expired licenses and 199 appraisers that had been state sanctioned. Inflated appraisals were common, which would obviously increase the costs of the loans and insurance costs with foreclosures. The second matter included a rule change, which had been introduced by the FHA in 2005 and announced through a Mortgagee Letter, altering the requirements for late endorsements for single-family insurance, where the endorsement was considered late if it is received by the FHA more than 60 days after the mortgage loan settlement or funds disbursement. This letter removed the prior six-month good payment history requirement for these loans, and added a 15-day grace period before the current month's payment was considered late.

The FHA did not carry out a risk analysis at the time, but the OIG did, and found that their review of loans from seven prior late endorsement audits (including Wells Fargo, National City Mortgage, Cendant and others) revealed a three-and-a half times higher risk of claims when loans had unacceptable payment histories within the previous six months. That was in 2006. Since then, the default rate has increased significantly for such loans. What was even more extraordinary was that the FHA continued to dispute the audit and did not publish a reversal of the rule, leaving the matter unresolved until 2009, when the whole matter was reported to Congress. All of this was despite the fact that HUD's own Handbook stated that, "Past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions."²⁰

A year later, in May 2010, Kenneth Donohue Inspector General again appeared before the same Senate subcommittee, and was able to acknowledge the considerable assistance given to him by the then Commissioner, David Stevens, "who has tried to do more in this last year than I saw in all the previous years

combined.”²¹ A few months later, Stevens departed to become Chairman of the Mortgage Bankers Association. Despite such efforts, Donohue’s report showed that little had changed, apart from the OIG and FHA’s decision to investigate 15 mortgage companies with significant claim rates. The result, as announced later that year, was that a further \$11m was lost due to non-complying loans. Fraudulent activities noted in his report included those of Lend America, which in 2008 alone made \$1.5bn in loans, and Taylor Bean Whittaker Mortgage Corporation and Colonial Bank with the result that the latter was taken over by the FDIC and sold to BB&T Bank, and the former was subject to seizure but at the time was servicing federally insured and guaranteed loans with a remaining principal balance of about \$26bn.

Once again, the point is not just the extent of the frauds, although they ran into billions of dollars. The real cause for concern was the ever-increasing size of the Single-Family FHA-insured loan portfolio, up to \$800bn in March 2010; by June 2010 it had reached \$865bn. The FHA insured 6.5m mortgages, of which 3.5m were put in place during 2008 to 2009. Its total endorsements increased to 74% of the insured mortgage market, which includes both home sales and refinances. Although fraud attracts attention because of the shock value of the bare-faced behavior of some of its perpetrators, the report is rightly focused on the FHA’s inability to assess the quality of the loans or the behavior of the lenders. The latest FHA report showed that net losses on claims were averaging 60%, which was 13% higher than predicted.

The report noted that the same problems arise with Ginnie Mae, which should also improve its approval process and recertification of issuers. The Taylor, Bean and Whitaker Mortgage Corporation (TBW) case exposed weaknesses not only in the FHA program, but also in Ginnie Mae’s program. Following the conviction of TBW, and the failure of the company to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Ginnie therefore defaults the issuers and assumes control of the issuer’s MBS pools. Their securities are the only ones to carry the full faith and credit guaranty of the US Government. In the case of the Colonial Bank, the FDIC temporarily froze the Ginnie Mae custodial accounts at the bank and as a result, Ginnie Mae was forced to make a \$1bn pass-through payment of principal and interest to investors. Such issues could arise again for Ginnie Mae, as the number of banks on the FDIC’s watch list continues to grow.

In his March statement to Congress, Commissioner Stevens explained the further actions that the FHA was taking to shore up its Capital Reserve Account, including the withdrawal of approval from 354 lenders; increases in premiums and the two-tier FICO requirement. These changes did not prevent the continuing rise in delinquent FHA loans throughout 2010, a figure which has been increasing over the past four years. It reached 619,712 in February 2011, for which the seriously delinquent mortgages are likely to end in default,

foreclosure or short sales as only 1% become paying loans, leaving the FHA exposed to \$1 trillion in FHA-insured mortgages.

Conclusion

This brief survey of HUD and its failure to oversee the federal affordable housing programs, taken together with the weakness of OFHEO, strongly suggest that it is simply not possible for the federal government to manage to provide affordable housing by these means. It never had the resources to do so, and successive Administrations were unwilling to provide them. Without proper oversight, millions, not to say billions of dollars were wasted on trying to provide affordable housing to those who did not have the income or assets to pay for them. The many-faceted nature of HUD requires careful examination of its role in ensuring that the FHA and Fannie and Freddie carry out their role of providing affordable housing with the interests of the minorities and low- to moderate-income families alone in mind.