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ROLE OF THE FEDERAL HOUSING ADMINISTRATION (FHA) IN ADDRESSING THE HOUSING CRISIS

HEARING

BEFORE A

SUBCOMMITTEE OF THE

COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

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ROLE OF THE FEDERAL HOUSING ADMINISTRATION (FHA) IN ADDRESSING THE HOUSING CRISIS

THURSDAY, APRIL 2, 2009

U.S. SENATE,
SUBCOMMITTEE ON TRANSPORTATION AND HOUSING
AND URBAN DEVELOPMENT, AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:01 a.m., in room SD–138, Dirksen Senate Office Building, Hon. Patty Murray (chairman) presiding.

Present: Senators Murray, Lautenberg, Bond, and Voinovich.

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. This subcommittee will come to order. This morning the subcommittee will hold its first hearing in the 111th Congress, and I can't think of a more timely subject for us to examine than the current economic crisis and its impact on homeowners across the country. There is no question that a perfect storm of Wall Street greed, irresponsible mortgage lending, and uninformed decisions by borrowers are at the heart of our economic crisis. What this subcommittee will explore today is what role the Federal Government and, more specifically, the Federal Housing Administration will play in the stemming of the housing crisis and assisting in our Nation's long-term recovery.

First of all, I'd like to extend a very warm welcome to our newly confirmed HUD Secretary, Shaun Donovan. Welcome. Good to have you here today. This is Secretary Donovan's first appearance before the subcommittee, but he and I have had many conversations about the challenges that HUD is facing on a wide variety of issues from homeless veterans to housing counseling to the foreclosure crisis.

We look forward to hearing from you today and to working with you to get the agency and the Nation headed down a sustainable path when it comes to housing.

I also look forward to hearing from our second panel of witnesses, including HUD Inspector General Ken Donohue, and from our two housing experts from my home State of Washington, Mr. Jay Lennox Scott, who's the Chairman and CEO of John L. Scott Real Estate, a family-run business for three generations, and Ms. Mia Vermillion, who is the Senior Mortgage Consultant with Guild Mortgage in Lakewood, Washington.

Now, I travel home every weekend and hear from my home State families about the challenges that they face, and I think it's important that Congress get on-the-ground perspective from experts in our communities who know what works and, alternatively, where there is room for improvement.

Our Nation is facing the worst economic crisis in generations. Since December 2007 we lost 4.4 million jobs, including 2.6 million in just the past 4 months. At the root of this crisis is years of reckless, unregulated, and irresponsible mortgage lending. Many of the mortgages that were initiated and then repackaged and sold during this period now have a new name: toxic assets. They are a significant portion of the assets that are poisoning the balance sheets of some of the largest financial institutions in the world, bringing uncertainty to the entire international banking system.

This impact has been felt in every sector of the American economy, stifling credit from car and student loans to the credit extended to help small businesses meet their payroll. It's important to note that the housing crisis is not just some abstract phenomenon impacting giant financial institutions. There are currently over 290,000 American homes in foreclosure, including 3,021 in my home State of Washington.

The housing crisis has swept across our communities and some are now calling on the Federal Housing Administration to be the savior of the market. The Federal Housing Administration was established in 1934 when the Great Depression ground the mortgage lending market to a standstill. The lending industry would only extend very short-term loans to high income households that could afford a very high down payment. Low- and moderate-income families had no hope of participating. So the FHA created a mechanism for working families to achieve the dream of home ownership. It also lowered the risk to lending institutions by putting the full faith and credit of the Government behind new affordable mortgages.

The FHA was an overwhelming success. FHA was there in good times and in bad, especially during recessions and periods of declining home values, as happened in the 1980s. Today, 75 years after its founding to help American families purchase a home, the FHA is now being called upon to keep millions of families in their homes. In 2007, when Commissioner Montgomery testified before us, it was to talk about the fact that the FHA was almost irrelevant to the housing market. At the time, the FHA's presence in the market had dropped to only 3 percent because so many lenders had taken advantage of the housing boom and instead offered exotic mortgages that families couldn't afford. The FHA's modest loan limits kept it out of many markets, including Seattle, King County the most populous county in Washington State.

Working with my colleagues, I was able to increase the FHA loan limits to make it relevant in these markets. But a lot of other things have changed with the FHA in a very short period of time that are threatening the integrity of the program and the taxpayers that stand behind it. The subprime market has now evaporated, and even the most creditworthy borrowers are having a hard time getting a mortgage.

I want to read to you a part of a letter from a constituent of mine in Kirkland, Washington, who, like a lot of Americans, has scrimped and saved and has good credit and yet still can't purchase a home of their own. They wrote to me and they said:

"In spite of my 18 years teaching public school in the Puget Sound region, my husband and I have been unable to purchase our own home. My husband was laid off from his job in 1998, returned to school to improve his employability, but couldn't for some time find more than part-time work.

"Now that we are finally in a more comfortable earnings bracket, we put every spare dollar into saving for a down payment and paying off the debt that we incurred during those darker days. Certainly there are many like us, unable to gather the money necessary to take the first steps to home ownership, but stably employed and with good credit, ready to make our own small contribution to the economy by taking on the responsibilities of home ownership."

That's not an unusual story and it's one of the many reasons that the solvency of the FHA is critical. The mission of the agency is to take care of creditworthy borrowers. Compared to the 3 percent market share FHA just had 2 years ago, today they guarantee over 25 percent of the total mortgage volume in the United States and the number of lenders with whom it does business has grown by more than 500 percent since fiscal year 2006. In Washington State, the number of FHA loans increased from just fewer than 9,000 in 2007 to over 30,000 in 2008.

We all want to lend a helping hand to the struggling families who need it, but we need to focus on exactly who the FHA can help through updated laws and revised policies. We don't want to invite a trend in which the worst mortgages are moved off the bankers' books and onto the Federal Government's.

My constituents have been clear that they don't want to wake up to learn that Congress has taken steps that leave the taxpayer holding the bag, and that's exactly what could happen if the FHA is pushed to buy loans that could go bad soon or down the line. We have to ensure that FHA has the tools and flexibility to charge enough in fees to cover its costs, because if the FHA can't pay its debts it will be up to this subcommittee to appropriate the funds to cover that shortfall and we do not have the dollars to do that.

We are in tough budget times. Every dollar we spend to cover defaults at the FHA is one less dollar going to public housing, homelessness prevention, or housing counseling to keep families in their homes.

This subcommittee has previously examined longstanding challenges at the FHA, like outdated technology, personnel shortages, and inadequate underwriting. Just because FHA has become a major player in saving the housing market doesn't mean those challenges have disappeared. As we talk about FHA's expanded role, we have to also discuss more rigorous underwriting and oversight.

I've convened this hearing with Senator Bond and I want to thank him for working with me on this because we want the FHA to be in a position to protect America's families and keep them in their homes, and to do that we have to ensure that the FHA isn't spread thin and it has the tools and resources needed to adequately staff, underwrite, and monitor its skyrocketing loan volume.

Both American homeowners and the American taxpayers deserve to know the Federal Government is acting responsibly and swiftly to help families in financial distress and to jump-start the ailing real estate market.

So I look forward to the testimony and responses of all of our witnesses today, and with that I want to turn it over to my colleague, the subcommittee's ranking member, Senator Bond, who has been very critical in helping us to put this together today. So thank you very much, Senator.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Madam Chair. I hope I've been critical in helping and not in criticizing.

Senator MURRAY. No, critical in helping, definitely.

Senator BOND. I begin by endorsing your warning that this subcommittee and our ability to provide the many needs in housing is threatened by a potential major drain on our resources we can't stand. I appreciate your calling this hearing, as I certainly asked you to do. I think it's time that we laid out where we stand.

I welcome our witnesses today. I congratulate the Secretary of HUD, Shaun Donovan, on his appointment and his willingness to take on a very challenging job during a very challenging time. I asked him repeatedly if he was willing to do it and he indicated that he was willing to take the chance. I know Secretary Donovan from his previous work. I've had good conversations with him. I am impressed with his knowledge, understanding, and his past forward.

I also recognize Mr. Ken Donohue, the HUD IG. Ken has done a great job of providing the Department and the Congress with independent and objective analysis and oversight of HUD's responsibilities.

Make no mistake, the health and solvency of FHA is at high risk. There are very troubling signs. FHA defaults are at their highest rates in several years. FHA's economic value had fallen by almost 40 percent over the past year. FHA-approved new lenders have increased by 525 percent over the past 2 years, and there are troubling signs that former subprime lenders and brokers have been approved to conduct FHA business. Fraudulent activity in the mortgage industry is on the rise, exposing FHA to more risk.

I've just been advised by the U.S. Attorney for the Eastern District of Missouri that she and her office have filed 58 individual and business criminal indictments, from large communities like St. Louis to small communities like Sykeston, and they have over 100 cases currently in review. That means the system is at risk.

FHA has a significant increase in foreclosures, which endanger the stability of communities and neighboring homes. The rise in FHA defaults and foreclosures, especially in areas already victimized by subprime lending, threaten to make a bad problem worse. It is clear that the families who suffer foreclosure go through a financial crisis. They go through a tremendous personal upheaval, losing their homes. But communities are suffering when the foreclosure rates become high. I've heard community leaders as well as housing advocates outline what happens to a community with foreclosures. Even on a broader basis, the geniuses on Wall Street who took these mortgages, securitized them, sliced them, diced them, and sent them out to poison not only our financial system, but the world's financial system, are really a very significant part of the worldwide economic crisis that we face right now.

Mr. Secretary, you inherited an agency that has longstanding challenges. I'm confident that you're up to the task of turning the agency around. I appreciate your recognition and willingness to tackle FHA's management and operational problems. But despite your skills and leadership, the Congress and the administration must not make your job harder by placing more risk on FHA until the problems are fixed, until the agency can handle it, or the agency will crash.

I believe I'm hearing from Americans there's a message for Congress and the administration: The taxpayer credit card is maxed out, the alarm has sounded. If Congress and the administration place more risk on FHA before the problems are solved, this powder keg will explode and taxpayers will be on the hook.

Now, we know that FHA has suffered from longstanding management and oversight problems, and in addition past administrations and Congress have contributed to FHA's woes by making changes to FHA so that it could refinance existing subprime mortgages. For example, the Bush administration created a new program called FHA Secure to allow the agency to refinance subprime borrowers who are late on a few payments. While the program served a fraction of troubled subprime borrowers and it was good, it did provide some assistance, the FHA terminated the program because of the negative financial impact on its insurance fund.

In addition, Congress created the FHA Home for Homeowners Program as part of last summer's Housing and Economic Recovery Act of 2008. Out of concern about the increased risk, the FHA spoke against and voted against the bill. While this $300 billion program has not served as many borrowers as anticipated, the Obama administration and some in Congress are advocating changes that would relax the standards of the program to increase participation.

In addition, there are efforts in the House to reestablish no down payment programs that significantly contributed to FHA's troubles. The seller no down payment program defaulted at an unacceptable rate, higher than subprime loans. As a result, I strongly oppose those efforts.

I look forward to working with the Secretary to ensure that you, Mr. Secretary, have the needed resources to carry out FHA's mission. It's vitally important that the FHA hire the necessary staff, provide consistent and comprehensive training, ensure that you install necessary safeguards to minimize fraud and abuse, and get your IT systems up to the modern day capabilities and the needs of the agency.

FHA has a very important role to provide home buyers with clear and comprehensive requirements, to help ensure the success of their home ownership. If the homeowners don't succeed, they lose, the communities lose, and we all lose.

Thank you, Mr. Secretary, for taking on this major task.

Senator MURRAY. Thank you, Senator Bond.

Mr. Secretary, we will now turn to you for your testimony. We do have your written testimony and we would ask you to summarize in about 5 minutes for the subcommittee.

STATEMENT OF HON. SHAUN DONOVAN, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary DONOVAN. Thank you very much. Chairwoman Murray, Ranking Member Bond, and members of the subcommittee. Thank you for the opportunity to speak with you today about the state of the Federal Housing Administration. I come before you in a historically unique moment. Our economy has deep challenges, unemployment is high, incomes are falling, and home foreclosures are greater than at any time since the Great Depression.

The Obama administration has responded with a comprehensive program to stimulate our economy and revive our housing markets. Last week President Obama announced his intention to nominate David Stevens to be the Assistant Secretary for Housing, and the Federal Housing Commissioner. I believe that Mr. Stevens is one of the best and brightest in the mortgage business, with a deep range of experience, and will be a steady hand in helping to manage through these challenging times.

Current market conditions highlight the critical role of the Federal Government in keeping mortgage credit flowing. In particular, FHA's role has grown substantially, from 3 percent of lending activity by dollar volume in 2006 to over 20 percent of all mortgages originated today.

Like other market players, FHA is experiencing elevated defaults and foreclosures, and with it losses that exceed prior estimates. In contrast to the subprime sector, where unsafe loan features and poor underwriting made those mortgages risky from the start, for FHA the primary reason for defaults and foreclosures continues to be economic factors, especially loss of income. FHA, however, is unlikely to face the catastrophic losses born in the subprime sector.

Moreover, much of our recent loss activities have been attributable to the growth in seller-funded down payment assistance, which accounted for a large and growing share of FHA losses and which Congress terminated last year. I thank you for your leadership on this issue and this should help to substantially reduce future losses in FHA's new business.

Several other factors should mitigate the damage in the current recession—that the current recession wreaks on FHA's portfolio. First, credit scores of FHA borrowers have risen markedly as tighter underwriting standards in the private market have driven better borrowers to FHA. Second, before mid-2008 FHA's loan limits reduced its market share and exposure in some of the Nation's highest cost housing markets, particularly in California.

My overall goal then is to continue efforts to identify both the existing strengths and to honestly look at the weaknesses of FHA, to work with Congress to make sure that FHA has the right program mix and pricing structure, is actuarially sound, and has the organizational infrastructure to continue to expand home ownership opportunities to those families traditionally not well served by the private marketplace.

Let me talk for a minute about the investments in both technology and human resources we need to make to build a sound infrastructure. FHA relies too heavily today on manual processes and needs to adopt more automated processes for underwriting and risk management. FHA staff spends too much time manually performing risk management duties, monitoring lenders and appraisers, and reviewing the underwriting of individual loan files. We must accelerate our adoption of market standard technologies for both of these areas.

Specifically, technology can also enhance FHA's fraud detection by borrowers, lenders and appraisers. We have already secured the use of anti-fraud technology for our Hope for Homeowners Program and are now looking to expand the use of that tool to all of FHA's single family business, beginning with a pilot application in fiscal year 2009.

These efforts tie in directly to the Obama administration's multi-agency combating mortgage fraud initiative. Under this initiative HUD and FHA will be playing a central role by investing in bringing anti-fraud systems on line. This initiative will also include additional resources from the FBI and the Justice Department to investigate and prosecute mortgage fraud.

I also want to say a special mention to the early cooperation and collaboration I have had with HUD's Inspector General, Ken Donohue.

Finally, as you well know, FHA's basic program data and technology systems are old and woefully inadequate. We will be requesting funding in our 2010 budget for IT investments and to prioritize the modernization of FHA IT systems, to upgrade our technology and core systems.

Automated tools to assist in risk management will be a good addition, but FHA also needs more staff and staff with a different skills mix than our current work force. I want to thank you, Chairwoman Murray, and members of the entire subcommittee for providing additional funding specifically for the Office of Housing to hire approximately 200 additional personnel in the fiscal year 2009 budget. The agency has already developed a staffing plan and job announcements are under way.

So my first priority is shoring up the basic infrastructure of the program. In addition, two other priorities are at the top of my list: helping homeowners avoid foreclosure and rethinking FHA's role in the new mortgage market. Last month, President Obama announced a bold plan to help borrowers avoid foreclosure. In addition to the making home affordable components, the President has called on Congress to enact carefully crafted bankruptcy reform along with important reforms to enable FHA to play a larger role in the overall effort to stabilize our Nation's housing market.

As you know, housing legislation, H.R. 1106, has passed the House and is now before the Senate. We hope it gets enacted quickly so that more borrowers can avoid foreclosures. There are two specific provisions that we'd like to see enacted: changes to Hope for Homeowners as a viable prevention, foreclosure prevention tool; and reform of FHA's loan modification process to allow FHA to enhance its use of partial claims authority, to align our loan modification activities with making homes affordable.

Finally, the recent mortgage market meltdown has provided ample evidence that we must work to rethink each and every aspect of the Nation's housing finance system. Building on its historic mission, I am committed to ensuring that FHA continues to provide liquidity and stability to the mortgage market, while at the same time developing the new products and programs that continue to expand access to home ownership to lower income and lower wealth households not well served by the private market.

PREPARED STATEMENT

In summary, I want to assure the subcommittee that, while significant challenges exist, the FHA is preparing to meet these challenges head on. I'm looking forward to having Dave Stevens confirmed and take the reins at FHA and look forward to answering your questions. Thank you.

[The statement follows:]

PREPARED STATEMENT OF HON. SHAUN DONOVAN

Chairwoman Murray, Ranking Member Bond, and members of the subcommittee, thank you for the opportunity to speak with you today about the state of the Federal Housing Administration (FHA).

I come before you in a historically unique moment. Our economy has deep challenges: unemployment is high, incomes are falling, and home foreclosures are greater than at any time since the Great Depression. The Obama administration has responded with a comprehensive and multifaceted program to stimulate our economy and revive our housing markets: a recovery package to create or preserve 3–4 million jobs, a comprehensive program to stabilize financial markets, lower mortgage interest rates and unfreeze credit markets; and new efforts to help homeowners refinance their mortgages, avert foreclosures, stabilize hard hit neighborhoods and end the downward pressure on housing prices.

HUD has a critical role to play in each of these areas. I am deeply appreciative of your subcommittee for providing HUD with $13 billion in recovery funds, including a new infusion of funding for the Neighborhood Stabilization Program to help communities prevent blight and make foreclosed homes community assets rather than liabilities. HUD has been deeply involved in the development of the Obama administration's Homeowner Affordability and Stability Plan (HASP), including the Making Home Affordable initiative that will allow 4 to 5 million homeowners now locked out of GSE refinance options to take advantage of today's lower rates, and help 3 to 4 million additional borrowers receive affordable, sustainable loan modifications and avert more costly foreclosures.

But no part of HUD is more central and important to our national effort to promote affordable homeownership than the Federal Housing Administration, and I am committed to making FHA as responsive to market demands as it was when it was founded.

FHA PAST AND PRESENT

As you all well know, the FHA was created in 1934 to address a set of economic conditions that were unquestionably of greater scale, but clearly of similar character to what we are facing today. Property values were declining. Unemployment was rising and incomes were dropping. Families could not pay their bills. It is no surprise that many homeowners could not meet their mortgage obligations. The overall contraction in the credit markets meant that borrowers had no place to turn to refinance out of their mortgages, which, at that point in history, were most often structured with 5-year terms and "balloon" repayment schedules.

FHA was set up as a Government mortgage insurance company to protect financial institutions from risk of loss and, in so doing, to encourage lenders to make longer-term, fixed rate home loans. The goal was to create liquidity and stability for the mortgage and real estate markets—to provide families access to credit, to keep them in their homes, and to offer homebuyers a new way to buy homes, by offering longer-term affordable financing.

The agency's mission has not changed since that time. As part of this mission, FHA continues to play a countercyclical role—serving as a backstop to the private mortgage market. FHA stays active in volatile and declining markets, continuing to make mortgage credit available to borrowers, even when private mortgage providers are withdrawing from the market. During difficult times, it is critically important to have an entity like FHA play this role—offering families access to near-prime rate financing. FHA picked up private market slack in Texas, Oklahoma and Louisiana during the Oil Patch bust in the late 1980s and in Southern California during the early 1990s, and it is playing this role again today.

Current market conditions highlight the critical role of the Federal Government in keeping mortgage credit flowing. With the collapse of global credit markets, FHA, Fannie Mae and Freddie Mac must continue to work with strong and well managed private sector entities to expand access to mortgage credit in the market. In particular, FHA's role has grown substantially from 3 percent of lending activity by dollar volume in 2006 to approximately 30 percent of all mortgages originated today.

FHA'S CHALLENGES

FHA is now playing a critical role in addressing the current mortgage crisis, but FHA also faces many challenges today. Like many Federal domestic agencies, FHA has suffered under the penny-wise and pound foolish priorities of the previous administration. FHA was stagnant, limiting its ability to maintain adequate staffing levels and invest in state-of-the art technology. Repeated budget stalemates and resulting uncertainty of future funding levels undermined the ability to implement long-term organizational improvements.

While FHA's volume of business has increased dramatically in the last 2 years and increased administrative appropriations will help ensure FHA properly oversees this workload. We certainly are appreciative of the additional funding and management flexibility we received in the fiscal year 2009 appropriations process and plan to bolster our staffing quickly. Outdated information technology (IT) systems, systems that were built to handle simpler and smaller mortgage programs, continue to serve as the primary vehicles for collecting, tracking, and validating program data and performance.

At the same time, I know that you Senator Murray and the rest of the members of this subcommittee share my concerns of the importance of helping FHA continue to operate safely and soundly in the current environment. Your actions in the fiscal year 2009 budget to allow FHA to have greater staffing and flexibility across the departments of the agency was a critical first step in helping to build a stronger and more market savvy FHA. But it was just a first step. For FHA to realize its full potential to respond to the current mortgage crisis it will require additional resources and development of new and innovative reform initiatives.

That is why I was so pleased last week when President Obama announced his intention to nominate David Stevens to be the Assistant Secretary for Housing/Federal Housing Commissioner. I believe that Mr. Stevens is one of the best and brightest in the mortgage business with experience ranging from mortgage originations, to secondary markets, to managing a national real estate firm. Should he be confirmed by this body, Mr. Stevens and I will work closely together to diagnose and address the challenges now facing FHA. Mr. Stevens brings a hands-on systems approach to mortgage origination, and is anxious to see firsthand the status of FHA's systems and programs and to quickly put in place process and technology improvements in all facets of FHA's operations

FHA PERFORMANCE TODAY

Prior to a fuller review, it is already clear to me that the agency has done good work in meeting the growing needs of the industry and the public. With resources constrained, the leadership and career staff at FHA have worked hard to process rapidly growing levels of new business, upgrade business processes and bring new FHA products—like FHA Secure and Hope for Homeowners—to market in record time.

But we all know that the FHA team cannot sustain their efforts and protect the programs over the long-term without an infusion of resources: for new staffing with new skills, investments in new state-of-the-art technologies, and new efforts to reach out to enforcement agencies at all levels of Government to better monitor FHA partners. In addition, the organization must continually rethink how to best reshape its product mix and pricing, particularly in light of today's dramatic market changes. The organization needs all of us to commit to providing the support needed to implement strategic improvements in its business operations and program designs.

As is the case with other mortgage market participants, currently FHA is experiencing elevated defaults and foreclosures and with it, losses that exceed prior estimates. In contrast to the subprime sector, where unsafe loan features and poor underwriting made those mortgages risky from the start, for FHA, the primary reason for defaults and foreclosures continues to be loss of income combined with low or negative home equity, and economic factors present in today's environment. Although this is a challenging time for all entities in the mortgage market, FHA is unlikely to face the catastrophic losses borne in the subprime sector. FHA loans continue to substantially outperform subprime loans: only 7 percent of FHA loans are seriously delinquent (greater than 90 days delinquent or in foreclosure) compared to more than 23 percent of subprime loans.

Moreover, much of our recent loss activities have been attributable to the growth in seller-funded down payment assistance. These loans grew from under 2 percent of all FHA home purchase originations in fiscal year 2000 to greater than one-third of purchase originations in fiscal year 2007 and 2008. The seller-funded down payment originations result in completed foreclosure at three times the rate of loans where borrowers provided their own downpayments and while they only represented 12 percent of the FHA portfolio at the start of 2008, accounted for 30 percent of all foreclosure completions that year. The termination of this program should substantially reduce FHA loses on new originations in the years ahead.

Several factors should mitigate the damage that the current deep recession wreaks on FHA's portfolio. First, before mid-2008, FHA's constrained loan limits reduced its market share and hence its exposure in some of the Nation's highest-cost housing markets, including California, where price declines and related foreclosure activity have been particularly intense.

Second, FHA has been attracting better quality borrowers in the last year. With much tighter underwriting standards in the private market, more higher quality borrowers can't qualify for conventional financing and end up with FHA-insured loans. Credit scores for new borrowers grew sharply in 2008, averaging over 680 at the end of 2008, compared to prior year averages of around 640. This is a positive development although, given the dynamic housing market, it is difficult to say how long this trend will continue in the future.

FHA is now playing its traditional role in today's turbulent market. But it's important to understand the positive trends as well. My goal is to continue my efforts to identify both the existing strengths and weakness of FHA, to work with Congress and the rest of the administration to make sure that FHA has the right healthy program mix and pricing structure, is actuarially sound, and the organizational capacity to continue to expand homeownership opportunities to those families traditionally not well served by the private market place.

ENHANCING FHA OPERATIONS

Since FHA insurance is backed by the full faith and credit of the United States Government, I want to assure the market participants that FHA insurance is as reliable as ever and there is no possibility of FHA "running out of money." Under authority provided to all Federal loan programs, FHA has indefinite resources to honor its outstanding commitments. At the same time, I want to reiterate my concern that FHA does need to make significant business process improvements to cope with growing demand and secure state-of-the-art fraud detection and risk management systems.

Expanding Use of Automated Risk Management Tools

It appears to me that FHA relies too heavily on manual processes and needs to adopt more automated processes for underwriting and risk management. Today, approximately 90 percent of FHA's 850 Office of Single Family staff and 100 percent of its contract dollars are devoted to risk management practices. They perform three types of risk management duties: assessing and monitoring business participants in FHA business, including lenders and appraisers; evaluating individual loan files to ensure compliance with FHA underwriting standards; and monitoring the entire insurance portfolio, by analyzing performance trends. The concentration of so many resources on quality control means that simply freeing up staff from other functions to provide additional support is not an option; there are very few staff who do anything but quality control.

Underwriting.—Working in partnership with the GSEs, FHA developed and utilizes an automated underwriting engine, but has not been able to keep it updated for analytic, market and technological changes. This is an area I'll look to improve. Greater reliance and application of automated underwriting systems would also enhance uniformity in the application of policy changes, which are now subject to interpretation by four FHA Homeownership Centers (HOCs). Getting organizational standards aligned with centralized oversight is critical, as is the need to continuously enhance the training of existing staff in FHA's own rules and procedures.

Fraud Detection.—Technology can also enhance FHA's fraud detection by borrowers. Automated risk management tools are being used industry-wide with great success, offering an efficient and effective means to access a large amount of critical information that can be used to detect the most common types of mortgage fraud—falsification of borrower identity, income, and employment and misrepresentation of property value.

Better automated tools will expand FHA's ability to closely monitor past and present practices of FHA-approved lenders and appraisers. Specifically, the best industry tools tap into public data sources that provide FHA with information that is not readily apparent in individual loan files or in the FHA-specific activities of lenders and appraisers. Access to this broader mortgage-related data set will help FHA uncover problematic practices before FHA insures loans or grants approval to lenders and appraisers to participate in FHA programs.

To that end, we have already secured the use of anti-fraud technology for our HOPE for Homeowners program and are now looking to expand the use of that tool to all of FHA's single family business. Unfortunately, by statute, the HOPE for Homeowners funding cannot be used to support the core FHA refinance and purchase programs. Thanks to our fiscal year 2009 appropriation, we now have funding and an existing contract to begin testing the use of the fraud detection tool on the entire FHA single family portfolio. The pilot will serve as the basis of the framework for full implementation of the tool in fiscal year 2010.

These efforts tie in directly to the Obama administration's multi-agency "Combating Mortgage Fraud Initiative." Under this initiative, HUD and FHA will be playing a central role, and the Department has requested additional 2010 resources specifically for investing in additional systems to enhance fraud detection and monitor lender originations. This initiative will also include additional resources for the FBI and the Justice Department to investigate and prosecute mortgage fraud.

Finally, as you well know, FHA's basic program data and technology systems are old and woefully inadequate. The basic IT infrastructure—both hardware and software—is outdated and inflexible. The various data systems are not well-integrated, so time is wasted reconciling data across systems that all collect the same information individually. Finally, and of greatest concern, the systems were written to support business procedures that have changed substantially and the tools themselves force FHA to maintain some practices that no longer make sense. To that end, we will be requesting funding in our fiscal year 2010 budget for IT investments and prioritize the modernization of FHA IT systems to upgrade our technology, to replace obsolete systems, and to invest in infrastructure that can support our core systems into the future.

Investing in Human Resources

Automated tools to assist in risk management will be a good addition, but FHA also needs more staff and staff with a different skills mix than our current workforce. We need to bolster specific expertise and skill sets: housing finance, including underwriting and appraisals; quality control and risk management; and policy analysis and communications. Recent hirings have brought some new skills, but with one of the oldest workforces of all Federal agencies, retirements continue to take their toll.

Therefore, I want to thank you, Chairwoman Murray and members of the subcommittee for providing an additional $12.7 million in funding specifically for the Office of Housing to hire approximately 200 additional personnel. The agency has already developed a staffing plan and job announcements are underway.

PRIORITIES GOING FORWARD

As noted earlier, my top priority for FHA is shoring up the basic infrastructure of the program to ensure that it continues to meet the needs of underserved borrowers through this current mortgage crisis.

Helping Borrowers Avoid Foreclosure.—Last month, President Obama announced a bold plan to help borrowers avoid foreclosure. In addition to the Making Home Affordable components that I mentioned earlier, the President has called on Congress to enact carefully crafted bankruptcy reform, along with important reforms to enable FHA to play a larger role in the overall effort to stabilize our Nation's housing market. As you know, housing legislation (H.R. 1106) has passed the House and is now before the Senate. We hope it gets enacted quickly, so that more borrowers can avert foreclosures

I would like to direct your attention to two critical elements of that package: proposed changes to Hope for Homeowners and reform of FHA's loan modification tools.

While Congress and the administration had high hopes for the Hope for Homeowners program when originally enacted last year, it has refinanced very few borrowers. I still believe in the original premise of Hope for Homeowners: that many investors would be willing to accept a refinance for less than the full amount of their loan to avoid the uncertain possibility of future defaults. It could fill an existing program void to refinance underwater borrowers who do not qualify for either the Making Home Affordable refinance or loan modification programs is a necessary addition to a comprehensive array of foreclosure prevention tools.

We look forward to working with you and other leaders in the Senate and House to develop a set of Hope for Homeowners programmatic reforms that will provide HUD greater flexibility to better meet this critical need in the marketplace.

In addition, I urge the Senate to enact pending provisions to enhance FHA's loss mitigation program. Specifically, we are anxious to incorporate new legislative authorities to enhance FHA's use of partial claims to help facilitate more aggressive and timelier modifications in FHA insured loans that are in imminent danger of default. These changes will more closely align the FHA loan modification program with the Making Home Affordable modification program in the conventional market. More importantly, these reforms hold the promise of reducing losses to the FHA fund by intervening at the earliest sign of mortgage payment difficulties

Creating New and Innovative Products.—FHA can also be a market leader in developing and introducing new mortgage products to make it easier and less expensive for homebuyers to finance energy improvements. Energy improvements reduce long-term costs to homeownership in the form of lower utility bills. In addition to making Energy Efficient Mortgages (EEMs) easier to obtain for homebuyers, we can work with Fannie Mae and Freddie Mac to coordinate product designs so that they are easily understandable and accessible to lenders and borrowers.

Getting to scale in energy efficient mortgage development will require the creation, testing and potential adoption of a range of approaches. The objectives for these programs include creating the proper incentives for energy-efficiency, being "user-friendly" to both borrowers and lenders, and exhibiting a sound cost and risk profile compared to other energy investments. Those approaches include streamlining HUD's existing, but under-utilized energy efficient mortgage program, and allowing greater flexibility in use of the EEM. The program would extend the benefits of the existing FHA Energy Efficient Mortgage (EEM) program to more homeowners through a coordinated approach that addresses supply-side, demand-side, and financing issues, while providing a mechanism for evaluating strengths and weaknesses of the initiative.

Rethinking FHA's Role in the 21st Century Mortgage Market.—The recent mortgage market meltdown has provided ample evidence that we must work to rethink each and every aspect of the Nation's housing finance system. Building on its historic mission, I am committed to insuring that FHA continues to provide liquidity and stability to the mortgage market, while at the same time developing the new products and programs that continue to expand access to homeownership to lower-income and lower-wealth households not well served by the private market. This is not to say that all households should become homeowners—we still need to provide decent and affordable rental housing to those who by choice or necessity remain as renters. But FHA has led the market in the past, and I am committed to making FHA once again a market leader.

CONCLUSION

In summary, I want to assure the subcommittee that while significant challenges exist, the FHA is prepared to meet these challenges head on. I'm looking forward to having David Stevens confirmed and take the reins at FHA.

Together we are committed to an ambitious reform agenda:

—Modernizing FHA's core technology systems;
—Enhancing our business practices;
—Ferreting out fraud among borrowers and lenders;
—Fixing and scaling up the Hope for Homeowners refinance program for "underwater" borrowers;
—Revamping FHA loan modification efforts to reduce foreclosures;
—Stimulating new energy efficiency mortgage products into the market; and
—Restoring FHA to a respected position of leadership in the marketplace.

I want to thank you for having me here and I'd be happy to answer any questions.

Senator MURRAY. Thank you very much, Mr. Secretary.

We are now going to a round of questions by subcommittee members. We will limit them to 5 minutes because we do have votes starting at 11:30 and we have a second panel. We want to make sure we have enough time to get to a second round for the Secretary as well as do that.

Let me begin, Mr. Secretary. Back in November right before the election, Business Week magazine published a cover story that was entitled "FHA-Backed Loans: The New Subprime." It pointed out instances where subprime lenders that had been disciplined in several States were being allowed into the FHA guarantee program. It pointed out times where companies that had officially filed for bankruptcy were still allowed to write mortgages with an FHA guarantee. It even pointed out companies that never verified incomes when they made subprime mortgages, but now have been allowed to reorganize themselves into companies that are participating with the FHA.

The number of brokers and lenders doing business now with the FHA has gone through the roof. As of the end of 2008, FHA had over 3,300 approved lenders. That is a 525 percent increase compared to 2006. When you add the number of brokers now doing business with the FHA, the numbers have skyrocketed from 16,000 in mid-2007 to 36,000 today.

I wanted to ask you if you believe the FHA has adequate procedures in place to screen out lenders and brokers that caused this housing crisis. And how do you do that when the number of lenders has increased by more than 500 percent in just the last 2 years?

Secretary DONOVAN. Chairwoman, a very, very important question. Let me start first by making a distinction that I think is critically important. I am absolutely concerned and very focused on the issue of ensuring that troublesome lenders don't migrate to the FHA programs. But I also want to be clear that FHA's products are not subprime products. We have never and we will never allow products that have exploding or hidden fees that are short-term with large adjustments in interest rates.

If you look at the default rates today and compare FHA's roughly 7 percent default rate to the roughly 23 percent default rate in the subprime market, I think it's clear that on a product basis FHA is not subprime and will never be subprime. That certainly will not happen under my watch.

TROUBLESOME LENDERS

But to get more directly to your question, there is absolutely more that we must do and that we are doing to ensure that we do everything we can to stop the migration of troublesome lenders into the FHA products. We've already taken significant action under my watch to begin to do that. In fact, today we are issuing a mortgagee letter to remind lenders of the procedures and processes that they must put in place.

A couple weeks ago we activated SWAT teams to look at and make visits unannounced to ten of the most troublesome lenders, and those teams will continue to focus on areas where we have troublesome data from those. There are a range of other things that I talked about in my testimony that we must do: improve our systems, improve our training and technology.

In addition to that, I would highlight that we have worked closely with you and the subcommittee and currently there are in the H.R. 1106 legislation that is before the Senate at this point increased authority that would allow us to screen out lenders where they have been suspended or debarred from other programs and to give us other additional authorities to stop the migration of lenders.

So while we are acting quickly to try and limit that, and I'm certainly concerned about it, I think there is also more that we can do on a legislative basis to try to make sure we do that.

Senator MURRAY. As an appropriation subcommittee, our interest is knowing, do you have the resources to adequately screen all of those people at this time?

Secretary DONOVAN. What I would say is that the additional resources that we were provided in the 2009 bill by you are very helpful, but I think we need to go further in addition, particularly on the systems front, and I look forward to working with you as part of the 2010 process, as well as report back to you on what we're doing with the investments in 2009.

Senator MURRAY. Okay and we will be asking those questions as we move forward.

Recently the FHA has experienced a spike in early payment defaults, defaults when the borrower has made no payment or very few payments before the FHA had to make good on its guarantee. In your view is this just a sign of a worsening economy or do you believe the FHA is now covering loans that should never have been made in the first place?

EARLY PAYMENT DEFAULTS

Secretary DONOVAN. We've looked carefully at this data and what we've seen is that early payment defaults have increased substantially, but they've actually increased slightly slower than the overall growth in the volume in the FHA program. So in other words, they've gone from about .8 percent to roughly .6 percent of all of the originations. So yes, there has been a significant increase. What we've also found is that the large majority of those early payment defaults result from job loss and other issues that are directly tied to the economy.

So, having said that, though, I do think there are—and I've talked with Ken Donohue very recently about this—there are ways that we can begin to ensure—and this was part of the mortgagee letter that we released today—to ensure that we are getting all of the detailed information we need on those early payment defaults, to look at them more closely and ensure that fraud is not happening even in a small percentage of those.

Senator MURRAY. Thank you very much.

Senator Bond.

Senator BOND. Thank you, Madam Chair.

I believe most people know my view on the no down payment mortgage issue, but for the record, with the movement starting on the other side for reinstating that, what's your view on no down payment mortgages?

Secretary DONOVAN. Let me start by saying thank you, Senator Bond, and to the chairwoman, for your leadership, and the entire subcommittee, on this issue. When you look at the facts, what we have seen is a dramatic increase in defaults from these seller-funded down payment programs. They have accounted for roughly a third of all the claims in recent months at FHA, and I think it's been a critically important change to make sure that we don't allow those types of programs to continue to hurt the future of FHA. So I want to thank you for your leadership on that.

Senator BOND. Thank you for your clear statement.

Mr. Secretary, on the question of defaults and foreclosures, how does FHA define a default and when does it move to foreclosure? We have, you said, 7 percent essentially in default. What—where do you decide when to go for mitigation into declaring a default or foreclosure? How does that process work?

LOSS MITIGATION

Secretary DONOVAN. Yes. I do want to say that there have been significant efforts at FHA around loss mitigation. I think we've seen through the efforts more broadly that we've made through the Making Home Affordable Plan that there is an opportunity to avoid the major costs that foreclosures have both on families and communities.

But as you rightly point out, there are situations where you can't go far enough to save that home and that foreclosure is the only option. What we've seen over recent months is that in roughly two-thirds of the cases where we have a default we are able to figure out some loss mitigation that will allow that person to stay in their home and to avoid foreclosure, whereas about one-third of the cases that we look at where they're seriously delinquent end up in foreclosure immediately.

What we've also seen—and you've been very clear that this is an important thing to look at; you're absolutely right—making sure that that loss mitigation that we're doing is successful in the long term. Our recent data indicates that 2 years after loss mitigation more than 90 percent of the modifications and adjustments that we're making continue to be successful. So we do feel like our loss mitigation efforts have generally been successful. We continue to look closely at the fact of whether there are other things we can do. We're making some modifications along the lines of the Making Home Affordable Plan. There are some changes in H.R. 1106 that we do think are helpful for partial payments of claim in certain situations that we don't currently have authority on. But that's an explanation of the way our programs are working.

Senator BOND. What is the cost on the two-thirds that you have been able to go into loss mitigation? Is there a portion of that loss assumed by the FHA? What are the costs of those mitigations to the FHA fund?

LOSS MITIGATION COSTS ON FHA FUND

Secretary DONOVAN. I actually have a precise number on that. This year there were about 48,000 loss mitigation cases and the cost of those mitigation efforts was about $107 million. If we had had a loss on all of those 48,000, the value of those mortgages was about $2.5 billion. I'm not saying we would have taken the full loss on that, but you can see that should they be successful, those loss mitigation efforts, that $107 million cost far outweighs the losses we would have had.

Senator BOND. Yes. We're all about keeping people in homes that they can afford and making reasonable adjustments. I'd like to see the originators sharing more of that cost and not just the taxpayers, because there ought to be some burden on the people who write the mortgages that aren't working. In the private sector, I know there is a loss. But certainly mitigation of $107 million compared to what the burdens would have been makes some sense.

Do you know how many mortgages currently are in mitigation and do they differ from State to State?

MORTGAGES CURRENTLY IN MITIGATION

Secretary DONOVAN. We do see significant differences State to State. I gave you the figure, the 48,000 that we've done over the past year. I don't have an exact number here. I'd be happy to provide you more information of the details of what's in mitigation.

What I would say is that, unlike the broader mortgage market, where our delinquencies in the rest of the market have been heavily concentrated in States like California, Florida, Nevada, about 50 percent of all foreclosures in the country are in California and Florida, we're seeing FHA's portfolio is, because of the loan limits, very differently spread geographically.

So Midwest is where we have a lot of our loss mitigation efforts and we have seen a higher level of foreclosures in those areas, Detroit in particular, Ohio. Senator Voinovich is here. We've had discussions about Cleveland and other efforts there where we can try to minimize the effect of those foreclosures in those communities.

Senator BOND. Thank you, Madam Chairwoman.

Senator MURRAY. Senator Lautenberg.

STATEMENT OF SENATOR FRANK R. LAUTENBERG

Senator LAUTENBERG. Thank you, Madam Secretary. I ask consent that my statement be included in the record.

Senator MURRAY. Without objection.

[The statement follows:]

PREPARED STATEMENT OF SENATOR FRANK R. LAUTENBERG

Madam Chairman, a home is more than just a building. It is a place of safety from the elements. It is a place for families to spend time together and for children to do their homework. And it is a source of financial security that families use to build their future.

That's the reason this housing crisis weighs so heavily on our Nation: it not only puts our economy at risk—it puts families at risk, too. Millions of families have already lost their homes because they were sold risky sub-prime mortgages—and millions more are at risk from job losses and other unexpected expenses. Instead of realizing the American Dream, 60,000 households in New Jersey may have their home taken away this year.

People are working harder than ever before—and still losing their homes. Congress and the administration must continue to take steps to stop the foreclosure crisis. The Federal Housing Administration will play a big role in our efforts. During the housing boom, homebuyers—even those who qualified for FHA-backed loans—turned to the private sector for their loans. But now that the housing bubble has burst, borrowers are turning back to the FHA again. The agency has become a life raft in a sea of debt for current homeowners looking to refinance into a fixed-rate mortgage. And it is a source of hope for first-time homebuyers.

I am pleased that the Economic Recovery law included a temporary increase of the FHA's maximum loan limit for high-cost metropolitan areas to help homeowners and homebuyers more easily get FHA loans. There are 12 counties in New Jersey that will benefit from this change and I encourage our residents to take advantage of these resources.

But with its new responsibilities and its new customers, FHA may not be able to keep up with consumer demands. When FHA lost business during the housing boom, it also lost staff and attention from the last administration.

The average computer system at HUD is about 18 years old. I came to the Senate from a company that depended on computers and technology. And I know you cannot manage billions of dollars worth of business with too few staff or technology that is outdated.

In these tough times, we need to make sure FHA has the funding and staff to do its job.

Americans are relying on FHA to provide mortgages, investigate fraud, and help revive the housing market. That is no small task. I look forward to working with this subcommittee to accomplish these important goals.

Senator LAUTENBERG. Mr. Secretary, when I see you here and look at your history of service to Washington and to a previous administration, you look so young. The job must be easy.

Right now New Jersey, for instance, currently has a surplus of vacant affordable housing because prospective home buyers can't find an agency to insure their loan. Now, will FHA consider changing its policy so it can start insuring loans on properties that are restricted for low- and moderate-income homeowners?

Secretary DONOVAN. Two things I would say about that, Senator. And I appreciate your comments about my appearance of youth despite the difficult circumstances that we're facing in the housing market and the country today.

LOW- AND MODERATE-INCOME HOMEOWNERS

What I would say is, first of all, that in many ways this is the time that FHA needs to be ensuring that there's adequate credit available to low- and moderate-income homeowners. We continue to be a source for people traditionally left out of the market, particularly low- and moderate-income buyers, to be able to become homeowners.

Further than that, as you point out, there are vacant homes around the country and it's been very important through our own foreclosures, as well as through partnership with funding that Congress has appropriated and we're very appreciative of through the recovery bill under the Neighborhood Stabilization Program, to begin to try to buy up and insure that foreclosed homes get rehabilitated and get sold again as quickly as possible, oftentimes to low- and moderate-income borrowers.

So we are working carefully, closely with our own portfolio of REO homes with Neighborhood Stabilization funding to make sure that we limit the period of time and the impact that those vacant homes have on communities, particularly low- and moderate-income communities.

Senator LAUTENBERG. So FHA essentially writes off the loss from what may have been a subprime loan, and that's FHA's responsibility, is it not? I mean, the failures are FHA's, fall into FHA's lap.

Secretary DONOVAN. We do not take losses on any subprime products. The subprime products have not been part of FHA's programs. We do have losses on traditional FHA products.

Senator LAUTENBERG. The regulations were there to prevent that from happening before the crisis began developing?

Secretary DONOVAN. That's right. But what we will do through the funding in the Neighborhood Stabilization Program, which runs actually through our Community Development Block Grant rather than FHA—that's where we have funding appropriated by Congress to work with local areas to acquire those homes that may have had subprime mortgages on them.

There also is the Making Home Affordable Plan, which is modifying loans to affordable interest rates that might have been subprime to begin with.

Senator LAUTENBERG. Because it's a sad situation to see people who need housing and empty houses and not to be able to at least get them out of the weather and keep them whole for a while.

Secretary DONOVAN. That's absolutely right. In fact, when the President put forward the Making Home Affordable Plan we did extensive research and believe that by stopping those foreclosures and avoiding the vacancies of those homes, the blight that they can introduce into a community, we can save all American homeowners, not just the foreclosed homes but all American homeowners, roughly $6,000 on average in the values of their homes. So that goes exactly to your point.

Senator LAUTENBERG. The FHA currently funds its own operations through homeowner fees. With the increase in demand for FHA-backed mortgages, can FHA adequately continue to help home buyers, homeowners, and still remain self-funded?

FHA SOLVENCY

Secretary DONOVAN. Let me say, Senator, we are looking very closely at that issue, at the premiums that we charge, at the losses that we have. At the time that we provide details of the President's 2010 budget, we will have detailed information in there about whether we believe the current insurance premiums fully cover the losses in the programs.

We have had to take over the last few years' additional losses against the claims and the foreclosures, but we are looking very carefully and we should within a few weeks be able to present to you our estimates of whether it will be self-financing in the current programs.

Senator LAUTENBERG. Thank you.

Thanks, Madam Chairman.

Senator MURRAY. Senator Voinovich.

STATEMENT OF SENATOR GEORGE V. VOINOVICH

Senator VOINOVICH. Thank you. I would like to ask that my written statement be made part of the record.

[The statement follows:]

PREPARED STATEMENT OF SENATOR GEORGE V. VOINOVICH

Thank you Senators Murray and Bond for holding this hearing on FHA's role in the current housing crisis. As many of you may know, Ohio has been hit very hard by the housing crisis, and I have long been concerned about the foreclosure tornado ripping through our cities and neighborhoods. According to the Mortgage Bankers Association's most recent report, Ohio is among the top 10 States in the Nation in foreclosures, 4.09 percent of mortgages are in foreclosure in Ohio and another 9.49 percent are past due. Unlike other States in the Nation, Ohio's housing crisis has not stemmed from speculation or the bursting of a housing bubble. The Foreclosure crisis in Ohio has been the result of the economic downturn and irresponsible lending practices.

Over the past few years, I have worked to stop the rise of foreclosures in my home State. I introduced the first piece of legislation enacted to address the foreclosure crisis, The Mortgage Debt Relief Act, which was signed into law December 2007. In addition, I have worked relentlessly for FHA reform. Last Congress, I introduced the Expanding American Homeownership Act to allow homeowners facing foreclosure or resetting interest rates to refinance without the usual burdens associated with a FHA loan by increasing and simplifying FHA's loan limits and loan terms. I was pleased when similar FHA modernization legislation was enacted in the Housing and Economic Recovery Act last summer. But I am also concerned about the recent trend of increased defaults of FHA loans and what this means for the solvency of the FHA. FHA must balance the responsibility to provide an adequate resource for refinancing with the responsibility to make sound loans. I look forward to hearing from our witnesses about additional ways we can increase FHA's fiscal soundness and effectiveness.

One of the primary missions of the FHA is to reach borrowers who are underserved, or not served, by the existing conventional mortgage marketplace. It is important that during this time of economic difficulty, FHA continue to serve this critical role in the housing market. During past recessions, including the downturns of the early 1980s, FHA remained a viable credit enhancer and was therefore instrumental in preventing a more catastrophic collapse in housing markets and a greater loss of homeowner equity. As housing prices fall and credit remains difficult to obtain, many homeowners and prospective homebuyers will need the less-expensive, safer financing alternative that FHA mortgage insurance provides. With the FHA's share of the mortgage market up from 2 percent 3 years ago to nearly one-third of mortgages today, there is no doubt that consumers are flocking to FHA loans.

As we continue to work together to restore the housing market and FHA's fiscal soundness, I hope the FHA can establish itself as a resource to the many families who are searching for a way to refinance in order to stay in their homes, or who are looking to make a first time home purchase, while maintaining their lending standards.

Senator VOINOVICH. The chairman has talked about the fact that you've had a 500 percent increase in lenders, and what I'd like to know is—you don't have to give it to me now because you probably haven't got the numbers—but how many people do you have working in that area right now, and with the additional work that you have are you going to be able to handle that work with the current folks that you've got, and how many more do you think would be needed to do the job the way it's supposed to be done?

INCREASE IN FHA LENDERS

Secretary DONOVAN. That's a very important question. First of all, let me just say, while we do have a large number of new applicants for FHA business—you've got the numbers right, over a fivefold increase in the last few years—our volume has gone up not quite that much, but close to that, and our largest 10 lenders continue to be roughly 90 percent of all loans originated. So while we do have lots of new lenders, they tend to be much smaller lenders and not in aggregate to originate that much of the business.

What I would say is we have begun hiring a significant number. I'd be happy to provide you detailed information about exactly how many of those folks are doing lender approvals and lender monitoring. But we have begun to increase that, and I think in the 2010 budget you'll see our proposal for the additional staff that we would need to be able to do that. I'd be happy to provide more details to you.

DEMOLITION OF PROPERTIES

Senator VOINOVICH. The other thing that we did when I talked to you in your office was the fact that in my city we have, the city of Cleveland, a provision that says that when you sell a property you're supposed to notify the person that it's on the demolition list. I'm pleased that you have changed that policy and you're going to abide by that ordinance, and I'm sure there are ordinances all over the United States like it.

The thing that's troublesome to me is that in so many of your properties they get on the demolition list, and when they do it appears that—for example, you're selling properties to the city of Cleveland right now that are in pretty bad shape. But you're expecting the city to pay for the demolition of those properties with the NSP funds or some other funds.

I just wonder why doesn't HUD, when they have properties that have so deteriorated that they have been condemned not pay for the demolition of those properties. I know you hire people to go out and they're supposed to maintain them, but from my experience they go out, they allegedly maintain them, and before you know it they're in a position where they're on the demolition list.

I just wonder if somebody ought to look at maybe the people that you're hiring to try and either get them to do a better job or look at it from the point of view that they're your properties, they've gotten in bad shape, and an ordinary person owning them would have to pay for demolition. Why doesn't HUD pay for the demolition?

Secretary DONOVAN. First of all let me say, the leadership and the approach that I want to bring to HUD is not to be defensive. You brought us an issue about the way we were coordinating or not coordinating with local areas on this issue of demolition and where homes have been condemned. You were absolutely right. We made a change to our policy that's now nationwide. So I want to thank you publicly for bringing that to our attention and working with us on that. That's the kind of approach I'll try to bring to any issue where we work together.

I think it is a fair point that we ought to be looking more broadly at our policies around our foreclosed homes and to be working more closely with cities across the country, and I think that is an issue worth looking at and evaluating whether we ought to be involved in the cost of the demolitions of those homes.

Senator VOINOVICH. I'd like you to look at it and the reason why you're not—from a public policy, it seems to me you should take care of them if you let them get in bad shape. But there's a reason why you don't have it in your budget to get the job done.

I've got three other questions real quick. One of them is, you've received recommendations for a change in regulations for the NSP program and I'd like to know the status of those recommendations, because they come from some very responsible organizations.

The other thing is, you've got the Home for Homeowners Program and then the President's Making Home Affordable and I'd like to have some written explanation as to what's the difference between the one program and the other program.

Last but not least, on the Homes for Homeowners or Hope for Homeowners, whatever they call it, that very few loans have been made under that program and I'd like to know why and what are you doing to remedy it so that more people will be able to take advantage of the program?

Secretary DONOVAN. Do you want me to answer now?

Senator VOINOVICH. No, I just pose those. I'd like to have those, the answers to that, in writing if I could.

Secretary DONOVAN. Absolutely, I'd be happy to do that.

Senator MURRAY. If you could provide those in writing, the subcommittee would appreciate it, knowing that as well. So thank you.

[The information follows:]

NEIGHBORHOOD STABILIZATION PROGRAM (NSP)

HUD has developed a document responding to several NSP issues: errors and omissions in the October 6, 2008 NSP notice as published in the Federal Register; policy changes recommended by grantees and interest groups; and statutory changes made by the American Recovery and Reinvestment Act (Recovery Act) to the NSP authorizing language in the Housing and Economic Recovery Act of 2008 (HERA). HUD will be proposing changes to several policy areas that have been of concern to grantees and interests groups, specifically the discount provisions and the need for full appraisals for de minimus value properties. The notice will also establish rules for treatment of program income generated from the use of NSP in light of the Recovery Act's repeal of the HERA revenue provisions and implement other changes mandated by the Recovery Act. HUD expects to issue this document in May.

HOPE FOR HOMEOWNERS PROGRAM

HOPE for Homeowners is not a different program but an integral part of the comprehensive approach embodied by the administration's plan, Making Home Affordable program, which is intended to bring stability to the housing market and help American families reduce their monthly mortgage payments to more affordable levels, or assist homeowners with loans owned or guaranteed by Fannie Mae or Freddie Mac an opportunity to refinance into more affordable monthly payments.

As an integral part of the Making Home Affordable program, a revised HOPE for Homeowners program would help reduce defaults and foreclosures. It would assist financially struggling homeowners by providing relief to them, stabilizing home values, and allowing lenders to liquidate toxic assets into new and performing assets. It is intended to help homeowners whose loans are not owned or securitized by Fannie Mae or Freddie Mac, who are behind on their payments, who owe far more than they are worth, and who may find that modifying the terms of their loans is not a workable solution. The program would assist homeowners by taking into consideration their ability to pay and making their mortgage sustainable over the long haul.

HOPE FOR HOMEOWNERS

There are significant barriers to participation created by the legislative language as evidenced by its restrictive eligibility requirements, its high costs to the consumer, and the departure from standard FHA business rules. Lenders have stated that they are reluctant to commit the resources to such a complex and costly program, and that it is more cost effective for them to focus their efforts on other available loss mitigation strategies to assist homeowners.

Consequently, the administration is seeking legislative amendments to the HOPE for Homeowners program as outlined in H.R. 1106, which would specifically lower costs to the consumer, ease the restrictive eligibility criteria, and make the program easier for lenders to offer. If the eligibility criteria are amended to allow more homeowners into the program, the premiums are reduced, and the program looks and feels more like a standard FHA program, HOPE for Homeowners would not only be a viable program, but would also be an attractive solution to the obstacles faced by both the consumers and lenders.

DEMOLITION OF PROPERTIES

On average, the Department annually acquires approximately 50,000 single family properties from HUD-approved lenders. To ensure that such properties are properly secured, maintained, and marketed for sale, HUD uses Management and Marketing (M&M) Contractors. These contractors are required to appraise HUD-owned properties using FHA Roster Appraisers, establish the list price for such properties, and market and sell properties for the maximum price the market will bear. The Department uses this disposition strategy as it is necessary to replenish the Mutual Mortgage Insurance Fund and is the most effective way for FHA to generate proceeds to provide homebuyers an affordable loan financing alternative to conventional and subprime loans.

Thus, HUD does not require its contractors to simply demolish its properties based on their appraised value. Instead, the conditions of the real estate markets are also factored in the contractors' determination of the ultimate disposition or sale of a property. In markets such as Cleveland, for example, "hard to sell" properties are offered to local governments at deep discounts to further the Department's affordable housing and neighborhood stabilization objectives. In addition, to the extent that the Department is aware of a HUD-owned property being condemned or due to receive a Notice of Condemnation, HUD's contractors have been directed to disclose this information to all potential purchasers of HUD homes.

Lastly, the Department, via its Neighborhood Stabilization Program (NSP), has awarded the city of Cleveland more than $16 million to address its high rate of foreclosed, abandoned properties, which contribute to blight within many of Cleveland's neighborhoods. Under the NSP program, local governments may acquire, demolish and rebuild, or rehabilitate foreclosed properties using NSP Federal grant funds. Additionally, to assist local governments in combating blight and in maximizing their use of the NSP grant funds, the Department is offering HUD-owned foreclosed properties valued at $20,000 or less (i.e., those considered to be "demolition properties") for $100. Specifically, 211 HUD-owned properties have been held off the market by the Department, pending a direct sale to the city of Cleveland. Many of these 211 homes are valued at $20,000 or less, with a collective value of $2,105,200.

Senator MURRAY. Again, we have votes in about 40 minutes. So I just have a couple of really quick questions and if anybody else has any quick ones. We want to get to the second panel.

The first one was about mortgage scams. We're seeing these signs in communities: Call 1–800. People are being ripped off. We put $2 million into the Appropriations Committee last year to deal with that and $6 million to the Neighborhood Reinvestment Corporation. Can you just share with the subcommittee really quickly what you are doing in terms of dealing with that?

MORTGAGE SCAMS

Secretary DONOVAN. Yes. This is a serious issue. I've seen it from my own experience as a local housing official, as well as the concerns that you're raising at the national level. Two things that we're doing: One is we're moving very quickly, and I've already sat down and met with Attorney General Holder about this issue, and we are beginning to work together with them, along with the FBI and our own IG, to try to target these rescue scams in a range of areas, as well as bringing in State attorney generals from around the country, who oftentimes are on the front lines of this issue.

I think you'll also see as we get into the details of our budget proposals that this is an area where we think not only through FHA, but also through our fair lending area, because often these scams tend to target minority communities more heavily than they do other communities, that we will have an increased focus both in funding and programs on this issue.

Senator MURRAY. We're going to continue to follow that as well.

I would like for you to provide in writing—we are guaranteeing loans now that are as large as $730,000. I supported that. I thought it was the right move. But I would like you to share with the subcommittee the default and delinquency experience of the borrowers with those higher loans as we look to what our next policy is going to be.

Secretary DONOVAN. Absolutely.

Senator BOND. Madam Chair, I'm going to keep this very short because I want to—we have to move on and we need to hear the IG. I would just note that last year, at the recommendation of the Treasury, I introduced the origination commission proposal to regulate the clicks. We regulate the bricks with the savings and loans and the banks, but nobody is regulating the people who don't originate loans, and that is one reason why I think there are 58 criminal indictments just in the Eastern District of Missouri alone and more than 100 under investigation.

I would like any thought that the Secretary has on whether that is the right way to go and any suggestions you have on the legislation.

I do want to ask one last question on the HECMs. How many have been originated and how many defaulted? Are there any specific problems with the implementation of the program and the financial risk to the United States?

HECMS

Secretary DONOVAN. I'd be happy to have a further discussion and provide you more detailed information on the HECMs. What I can tell you because of the nature of the program it doesn't have a default issue per se in the same way. But what we've seen is in the entire history of the program under 10,000, about 9,300 HECM loans have been assigned to HUD out of a total of 391,000 loans. So it's a very small percentage.

We do see some increase, given the economic climate recently, in HECM borrowers who are unable to pay their taxes and insurance, and we are looking very carefully at that issue to make sure that our HECM lenders are responding appropriately. I think that's an area where we have to make sure that we don't end up, because of the nature of the HECM program, with a problem down the line. So that's an area where we need to have some increased focus.

Senator BOND. I should have phrased the question differently. But if people start living a whole lot longer, as all of us senior citizens hope we will, there is a potential downstream risk, and I don't know whether you've looked at it. We'll be happy to discuss that with you.

Thank you, Madam Chair. Thank you very much, Mr. Secretary.

Secretary DONOVAN. Thank you, Senator.

Senator MURRAY. Mr. Secretary, thank you very much for your testimony today. We will have a number of questions in writing that we'll submit to you and hope we can get a prompt response. But thank you very much.

Secretary DONOVAN. I appreciate your interest in this issue and all of the collaboration we've had thus far. Thank you.

Senator MURRAY. We will now turn to our second panel and if those witnesses would please come forward. We're going to be hearing from our Inspector General, the Honorable Kenneth Donohue, who will begin his testimony as soon as he is at the table here. We also will be hearing from Mr. Lennox Scott, who is the Chief Executive Officer of John L. Scott Real Estate in Bellevue, Washington, and Ms. Mia Vermillion, who is a Senior Loan Consultant with Guild Mortgage in Lakewood, Washington.

So once our witnesses are in front of us we will begin their testimony. I want all of you to know we do have your testimony in writing. It will be part of the record and we would ask each of you to limit your verbal testimony to 5 minutes.

Mr. Donohue, we'll begin with you.

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

Mr. DONOHUE. Chairman Murray, Ranking Member Bond, members of the subcommittee, thank you for inviting me here today. I appreciate the opportunity to testify on the role of FHA in addressing the housing crisis.

Through our work in auditing and investigating many facets of FHA programs over the course of many years, we have had concerns regarding the FHA systems and infrastructure to adequately perform its current requirements. This was expressed by the OIG to the FHA prior to the current influx of loans and numerous proposals that expanded its reach. We remain keenly interested in FHA's ability and capacity to oversee newly generated businesses.

The volume of single family loans has increased by tripling from $59 billion in 2007 to over $180 billion in 2008. FHA's share of insured endorsements has increased from 21 percent to 70 percent, which includes home sales and refinancing.

We believe there's a critical need for more resources for FHA: (1) to enhance its IT systems; (2) to increase personnel to deal with escalation in processing requirements; (3) to increase its training of personnel to maintain a workforce with the necessary skills; (4) to oversee the numerous contractors it maintains; and (5) to increase its oversight in all critical front end issues, including areas such as appraisal, lender approval, and underwriting process.

We are gratified the new penalty provision we helped craft was inserted into the HERA bill. That statute now creates a penalty for committing fraud against FHA programs and will be a useful tool for prosecutors and the law enforcement community to employ.

The results of the latest actuarial studies show that HUD has sustained significant losses in its single family programs, making a robust program reserve smaller. As of September 30, the fund's economic value was an estimated $12.9 billion, an almost 40 percent drop from over $21 billion a year ago. The current value represents 3 percent of the mortgages insured by FHA. Although above the 2 percent ratio required by law, it is below the 6.4 percent ratio for the same time last year.

If more pessimistic assumptions are factored in, the ratio could dip below 2 percent in succeeding years, requiring an increase in premiums or Congressional appropriation intervention to make up the shortfall.

The tightening credit market has increased FHA's position as a loan insurer and with that is coming an increase in lenders and brokers seeking to do business with the Federal programs and a concern regarding some of these loan originators. For example, we currently have under investigation several FHA lenders who are also lenders in the subprime market. The movement towards HUD is already under way, as reflected in the recent statistics. FHA lender approvals increased 525 percent in a 2-year period. We note that FHA and GNMA's lenders and issuers' approval processes are largely manual. Both groups will be challenged within current constraints to keep up with the increased volume. Given the recent aggressive history of the industry that is now seeking to do business with the FHA, we think it may be prudent to review standards for participation.

As you can see from my exhibit, the current application contains a certification for those seeking to do business with GNMA that if they knowingly make a false statement they could be subject to criminal penalties, such as 18 U.S.C. 1001. There are no such attestation requirements for lender applicants with the FHA.

Moreover, we have recently initiated inspection of the mortgage review board enforcement actions and its effectiveness in resolving cases of serious noncompliance with FHA regulations, particularly during the period of significant changes in the housing market.

Another area of concern is the growing home equity conversion mortgage program. We are aware that the larger loan limits can be attractive to exploiters of the elderly whether it is by third party or even family members who seek to strip equity from seniors. Due to the vulnerability of the population this program serves, we are also concerned about the evasions of statutory counseling requirements.

PREPARED STATEMENT

Finally, the HUD IG has initiated a broad range of strategies to leverage limited resources. As you can see from the other exhibit, we are key partners in a variety of Federal and State task forces, such as the Department of Justice National Mortgage Fraud Teams and in many key jurisdictions across the country.

Thank you, madam.

[The statement follows:]

PREPARED STATEMENT OF HON. KENNETH M. DONOHUE

Chairwoman Murray, Ranking Member Bond, and members of the subcommittee, thank you for inviting me to testify today. I very much appreciate the opportunity to speak on the important issue of the role of the Federal Housing Administration (FHA) in addressing the housing crisis currently confronting our Nation.

BACKGROUND

The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The OIG strives to make a difference in HUD's performance and accountability. The OIG is committed to its statutory mission of detecting and preventing fraud, waste, and abuse, and promoting the effectiveness and efficiency of Government operations. While organizationally located within the Department, the OIG operates independently with separate budget authority. This independence allows for clear and objective reporting to the Secretary and to the Congress.

The Department's primary challenge is to find ways to improve housing and to expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs, which include Federal Housing Administration (FHA) mortgage insurance for Single-Family and Multifamily properties, are funded through a $45+ billion annual budget and, in the case of FHA, through mortgage insurance premiums.

The last 2 years have seen enormous and damaging developments in the mortgage market: the dissolution of the subprime and Alt-A loan markets; dramatic drops in housing prices in most areas of the country; a concomitant rise in default and foreclosures; financial insecurity in the mortgage-backed securities markets represented by the Government takeover of Fannie Mae and Freddie Mac; the collapse of credit markets; and, as a primary vehicle to address these issues, an urgent reliance on the FHA to bolster the mortgage market. As the Mortgage Asset Research Institute has stated, the unprecedented onslaught of financial losses, reputational damages, and rehabilitative public policies will forever reshape the mortgage industry.

While there are other programs at HUD that are being utilized in a significant way to help stimulate the economy (i.e., billions of dollars in new funding to Community Development Block Grants, to increased Public Housing assistance, etc.), which are also vulnerable to fraudulent and abusive activities, the focus of this testimony is on the salient issues facing the FHA program due to the mortgage crisis and to an increased reliance on our Department to resolve foreclosure matters at this critical juncture. The current degree of FHA predominance in the market is unparalleled.

First off, to put the FHA issues into perspective, we have recently stated in testimony to the Congress that, through the multitude of our work in auditing and investigating many facets of the FHA programs over the course of many years, we have had, and continue to have, concerns regarding FHA's systems and infrastructure to adequately perform its current requirements and services. This was expressed by the OIG to the FHA through audits and reports regarding a wide spectrum of areas prior to the current influx of loans coming into the program and prior to the consideration of the numerous proposals that expanded its reach. We continue to remain concerned regarding FHA's ability and capacity to oversee the newly generated business.

Some of these are long-standing concerns that go back to unresolved issues highlighted in our work products from as far back as the early to mid-1990s. In my discussions with the Secretary, it is clear he is committed to positioning the Department as rapidly as he can to try to deal with the changing dynamics. As the President recently stated, however, the Government is an ocean liner, and not a speed boat, when it comes to moving it in a new direction. The same can be said for some of our departmental programs.

THE EVOLVING LANDSCAPE

The past year and a half have certainly produced a lot of changes and initiatives. In response to increasing delinquencies and foreclosures brought about by the collapsing subprime mortgage market, in September 2007, HUD acted administratively to provide mortgage assistance through the FHA Secure program to refinance existing subprime mortgages. The program was expanded in May 2008 to provide lenders 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. This program served a fraction of its anticipated scope. The FHA recently issued a formal letter terminating the program stating that "maintaining the program past the original termination date would have a negative financial impact on the MMI Fund."

The Housing and Economic Recovery Act (HERA) passed last summer, created a new Hope for Homeowners program to enable FHA to refinance the mortgages of at-risk borrowers. While activity to date has been limited, the FHA was authorized to guarantee $300 billion in new loans to help prevent an estimated 400,000 homeowners from foreclosure. The Congress is working on legislation to revise this program so as to increase participation. These proposals, and others, to remedy a dysfunctional mortgage market are likely to increase the challenges to the OIG. While the goal to help homeowners in distress is important, a redraft to relax qualification requirements for borrowers and lenders may create a situation that could be exploited by fraud perpetrators to take advantage of desperate homeowners, at risk-lenders, and the FHA insurance fund. The HERA legislation also authorized changes to the FHA's Home Equity Conversion Mortgage (HECM) program that will enable more seniors to tap into their home's equity and obtain higher payouts which raises new oversight concerns for this agency.

As we turn to today's environment, the volume of Single-Family FHA-insured loans has enlarged in fiscal year 2008 by tripling from $59 billion in fiscal year 2007 to over $180 billion in fiscal year 2008. The latest figures from Single-Family market comparisons from the first quarter of fiscal year 2009 show that FHA's total endorsements have increased from 21 percent of the market the year before to 70 percent of the market which includes both home sales and refinances. FHA's home sales' market share (excluding refinances) has increased from approximately 6 percent to close to 20 percent during this time period. Many potential homeowner loans may not have come to the agency yet as some of the new initiatives are still taking hold and the industry is flushing out its options and possibly posturing for more favorable terms.

FHA will be challenged to handle its expanded workload or new programs that require the agency to take on riskier loans then it historically has had in its portfolio. This surge in FHA loans is likely to overtax the oversight resources of the FHA, making careful and comprehensive lender oversight difficult. In addition, our experience in prior high FHA volume periods (such as from 1997–2001) shows that the program was vulnerable to exploitation by fraud schemes, most notoriously flipping activities, that undercut the integrity of the program.

DEPARTMENTAL ISSUES

It is our understanding from the Department that, even with the projected increase in FHA business, they are planning for only 40 more staff positions starting in fiscal year 2009. It remains very tight particularly as it relates to departmental oversight. For example, the mortgage licensing provisions contained in the new legislation set minimum standards for nationwide licensing and a registration system for mortgage broker and loan officers. When we last testified earlier in the year, we had been told that there was one FHA person in the RESPA (Real Estate Settlements Procedure Act) unit who was assigned to work with the States in complying with this new regulatory requirement.

Though the recently-passed Omnibus Appropriations bill containing fiscal year 2009 funding will help to alleviate some of its funding constraints, we believe there is a critical need for more resources for FHA: (1) to enhance its IT systems; (2) to increase its personnel to meet the escalation in processing requirements; (3) to increase its training of personnel to maintain a workforce with the necessary skills to deal with the responsibility of this new portfolio; (4) to oversee the numerous contractors it maintains; and (5) to increase its oversight of all critical front-end issues including such important areas as the appraisal, lender approval and underwriting processes.

We are also concerned that increases in demand to the FHA program are having collateral implications for the integrity of the Government National Mortgage Association (Ginnie Mae) mortgage-backed securities (MBS) program including the potential for increases in fraud in that program. HUD too needs to consider the downstream risks to investors and financial institutions of Ginnie Mae's eventual securitization of a large proportion of the Hope for Homeowners and Home Equity Conversion Mortgage (HECM) Single-Family loans. Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuer's MBS pools. Like FHA, Ginnie Mae has seen an augmentation in its market share (it has even in some recent months surpassed both Fannie Mae and Freddie Mac) and increased $150 billion in outstanding mortgage-backed securities and commitments during a 1 year period from fiscal year 2007 to fiscal year 2008. It too has stretched and limited resources to adequately address this increase. From a different vantage point, the industry has noted that Ginnie's struggle to keep pace with FHA could also reduce liquidity at a critical moment in the housing market.

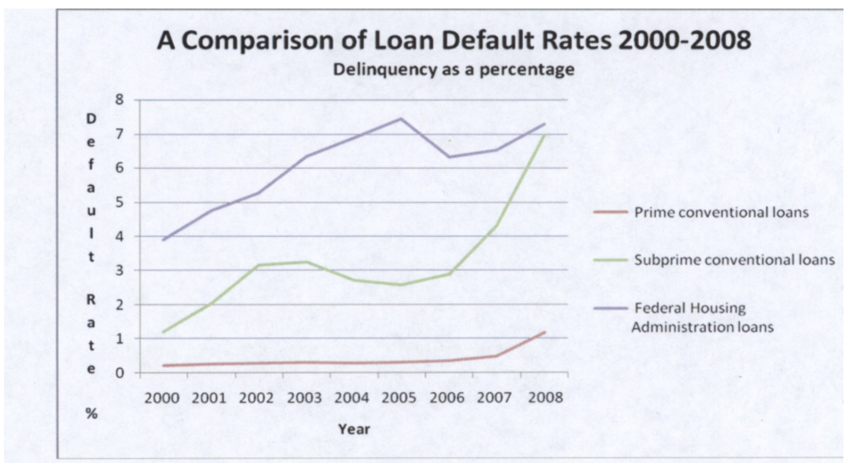
The OIG has initiated investigations of Ginnie Mae MBS fraud. In one recent case, the two former corporate officers of a Michigan financial company were convicted of defrauding Ginnie Mae by retaining the funds obtained from terminated and/or paid off loans. The defendants failed to disclose to Ginnie Mae that the loans were terminated, while one of the defendants utilized the funds from the paid-off loans to invest in the stock market and to make fraudulent monthly payments to Ginnie Mae on the loans that were previously paid-off in order to conceal the fraud. The fraud began during July 1998 and continued until October 2007, resulting in a loss of approximately $20,000,000.

Despite all these enumerated issues, we are gratified that a new penalty provision was inserted into the Housing and Economic Recovery Act (now 18 U.S.C. section 1014). When we corresponded during consideration of that legislation, we stated our belief that a new penalty enunciated specifically for the FHA program would be beneficial from an oversight and enforcement perspective. We assisted in its development and were very pleased that it was included in the final passage. The statute now creates a penalty of up to $1 million and 30 years in prison for committing fraud against FHA programs, similar to the predicates established in the Financial Institutions Reform, Recovery and Enforcement Act, and will be a useful tool for prosecutors and the law enforcement community to employ in order to address those who would seek to defraud the program.

OIG OBSERVATIONS

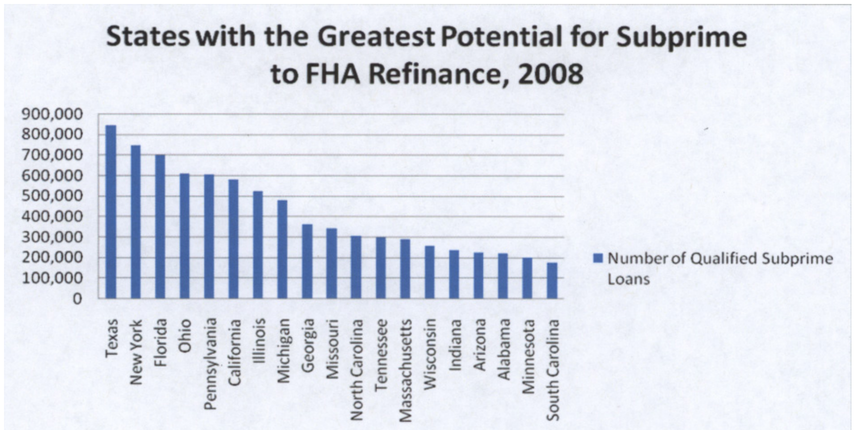
The results of the latest actuarial study show that HUD has sustained significant losses in its Single-Family program making a once fairly robust program's reserves smaller. The study shows that FHA's fund to cover losses on the mortgages it insures are contracting. As of September 30, the fund's economic value was an estimated $12.9 billion, an almost 40 percent drop from over $21 billion a year ago. The $12.9 billion economic value represents 3 percent of the mortgages insured by the FHA. Although above the 2 percent ratio required by law, it is well below the 6.4 percent ratio from the same time last year. Moreover, these latest projections used macroeconomic forecast data as of June 2008 and are profoundly sensitive to the accuracy of those forecasts. If more pessimistic assumptions are factored in, the ratio could dip below 2 percent in succeeding years requiring an increase in premiums or Congressional appropriation intervention to make up the shortfall. We think it might be useful for the Department to conduct interim assessments of the viability of the fund. Further, the new Office of Management and Budget (OMB) Director is quoted in a March 18, 2009 online OMB blog as saying that the Congressional Budget Office recently estimated FHA loans of the last few years as accruing $15 billion in losses, and that OMB needed to move the true costs of this program to the budget's discretionary ledger. Since its inception in 1934, FHA has been self-sustaining and premiums paid to the fund have covered the losses due to fluctuating defaults and foreclosures.

A significant problem facing FHA, and the lenders it works with, is the fallout from decreasing home values. This increases the risk of default, abandonment and foreclosure, and makes it correspondingly difficult for FHA to resell the properties. About 7.3 percent of FHA loans are currently in default (i.e., more than 90 days non-payment status, foreclosure or bankruptcy). The Mortgage Bankers Association reports a 30-day + delinquency rate for FHA loans of about 13 percent. A major cause for concern is that even as FHA endorsement levels meet or exceed previous peaks in its program history, FHA defaults have already exceeded previous years. Default levels on FHA loans are above those for prime conventional loans as evidenced below:



Sources:
FHA Data From HUD Single Family Data Warehouse Defaults By State Table
Prime and Subprime Data From Mortgage Bankers Association (Provided by HUD PD&R)

This reinforces the importance for FHA approved lenders to maintain solid underwriting standards and quality control processes in order to withstand severe adverse economic conditions. Another extensive problem confronting FHA has been its inability to upgrade and replace legacy (developed in the 1970s and 1980s) application systems that had been previously scheduled to be integrated. The FHA systems environment remains at risk and must evolve to keep up with its new demands. Add to that an escalation in the properties owned and managed by FHA and the overall picture becomes more complicated. The chart below is an OIG analysis of some areas of the Nation and of the projected potential impact of subprime loans refinanced to FHA.



INCREASED RISKS TO FHA

Until recently, FHA's market share remained quite low as conventional subprime loans were heavily marketed by lenders. The tightening credit market has increased FHA's position as a loan insurer and, with that, is coming an increase in lender/brokers seeking to do business with the Federal program and an overall concern regarding some of these loan originators. For example, we currently have under investigation for alleged inappropriate activities several FHA lenders who were also lenders in the subprime market. The movement toward HUD is already underway as reflected in recent statistics. FHA approval of new lenders increased 525 percent in a 2 year period. For example, as of the end of fiscal year 2008, FHA had over 3,300 approved lenders as compared to 997 at the end of fiscal year 2007 for an increase of 330 percent. If you compare the fiscal year 2008 totals (over 3,300) to the fiscal year 2006 totals (692) it is a 525 percent increase. Lender approvals for fiscal year 2009 currently total over 1,600.

The integrity and reliability of this crop of program loan originators is, in our view, unproven and, in light of the aggressive recent history of this industry, may pose a risk to the program. The Mortgage Bankers Association (MBA) in recent testimony stated the "MBA is concerned that since the once lucrative subprime market has evaporated, some of the less scrupulous lenders who specialized in that business are now turning their attention to FHA lending."

In addition, we have seen lenders reacquiring FHA approval despite past abuses. A previous investigation on an FHA lender in New York led to the debarment of its owner for a period of 5 years from originating FHA insured loans. After the debarment was served, the lender, under the same owner, resumed operations using the same fraudulent practices. We again reviewed some of the loans and determined that the originations were fraudulent similar to the loans investigated in the first case. The OIG, in conjunction with the U.S. Attorney's Office and departmental officials, sought and received an injunction against them in order to stop the business from operating. Following the injunction, FHA withdrew their lender approval.

Our audit work also highlights how problem lenders may regain admission into the FHA program even when previous transgressions were apparent. For example, we reviewed an Arizona corporation that was approved as an FHA mortgage lender by HUD in 1996. This particular lender had 13 active branch offices and sponsored close to 2,000 FHA-approved loan correspondents nationwide. As highlighted in our audit, this lender had a number of serious issues related to RESPA violations such as paying marketing fees, non-competition fees and quality incentives to real estate companies in exchange for more than $57 million in FHA mortgage business. The corporation's license was suspended by the State and it filed for bankruptcy. One of the principal owners and principal managers reconstituted under a different name but operates from the same location. In 2008, HUD approved the new entity to originate and process FHA loans despite its principals' prior citations for RESPA violations.

Adding to the risk, FHA is now, due to loan limit increases, serving new metropolitan areas with which it previously has had little interaction. Recent legislation increased maximum FHA loan limits to $729,750. With such entry, come new players and unknown hazards. The effects of this significantly increased loan limit are potentially much greater losses sustained by FHA on defaulted loans and that the loans may be much more attractive to perpetrators of fraud who will be able to extract greater payouts in fraudulent loans schemes.

Simultaneous to this confluence of events, is an increase in the reported incidents of mortgage fraud. As the Federal Bureau of Investigation (FBI) points out, a significant portion of the mortgage industry is void of any mandatory fraud reporting and presently there is no central repository to collect all mortgage fraud complaints. Mortgage fraud incidents reports, as compiled, however, by the Mortgage Asset Research Institute in the overall marketplace, have increased by 45 percent in the second quarter compared to a year-ago period. It's most recent third quarter assessment states that fraud incidence is at an "all-time high" and that "reported mortgage fraud is more prevalent now than in the heyday of the origination boom."

Our long-term investigative exposure in the area of mortgage fraud schemes impacting both FHA and conventional loans (since most fraud schemes cross loan programs) has given us vast experience and extensive knowledge. Many "traditional" fraud schemes continue to affect FHA and are described below:

—*Appraisal Fraud.*—Typically central to every loan origination fraud and includes deliberately fraudulent appraisals (substantially misrepresented properties, fictitious properties, bogus comparables) and/or inflated appraisals (designed to "hit the numbers"); appraiser kickbacks; and appraiser coercion.

—*Identity Theft.*—Often includes use of bogus, invalid or misused Social Security numbers and may include involvement of illegal aliens, false ownership documents or certifications.

—*Loan Origination Fraud.*—Including false, fraudulent and substantially inaccurate income, assets and employment information; false loan applications, false credit letters and reports; false gift letters; seller-funded down payments; concealed cash transactions; straw buyers; flipping; kickbacks; cash-out schemes; fraud rings; and inadequate or fraudulent underwriting activities.

While these types of mortgage fraud schemes continue to operate, changing market conditions have generated new, or variant, schemes:

—*Rescue or Foreclosure Fraud.*—Recent trends show that certain individuals in the industry are preying on desperate and vulnerable homeowners who are facing foreclosure. Some improper activities include equity skimming (whereby the homeowner is approached and offered an opportunity to get out of financial trouble by the promise to pay off the mortgage or to receive a sum of money when the property is sold—the property is then deeded to the unscrupulous individual who may charge the homeowner rent and then fails to make the mortgage payment thereby causing the property to go into foreclosure) and lease/buy-back plans (wherein the homeowner is deceived into signing over title with the belief that they can remain in the house as a renter and eventually buy back—the terms are so unrealistic that buy-back is impossible and the homeowner loses possession with the new title holder walking away with most or all of the equity).

—*Bankruptcy Fraud.*—Typically chapter 7 bankruptcy petitions are filed in lieu of chapter 13 petitions on behalf of debtors; however, property sales information is fraudulently withheld from the bankruptcy court and the properties are leased back to the debtors at inflated rents. The debtors' property ownership and equity are stripped from them.

—*Home Equity Conversion Mortgage (Reverse Mortgage) Fraud.*—FHA reverse mortgages are a new and potentially vulnerable area for fraud perpetrators. We are aware that the larger loan limits can be attractive to exploiters of the elderly, whether it is by third parties or by family members, who seek to strip equity from senior homeowners. Due to the vulnerability of the population this program serves, we are also concerned about evasions of statutory counseling requirements or of fraud by counseling entities. We are working with the chairman and members (Senator McCaskill, in particular) of the Senate Committee on Aging and the chairman of the House Committee on Financial Services to address some of their concerns regarding these issues. We have also been partnering with the AARP and other groups to foster consumer protection education awareness. The following represent some of the types of schemes that we are encountering:

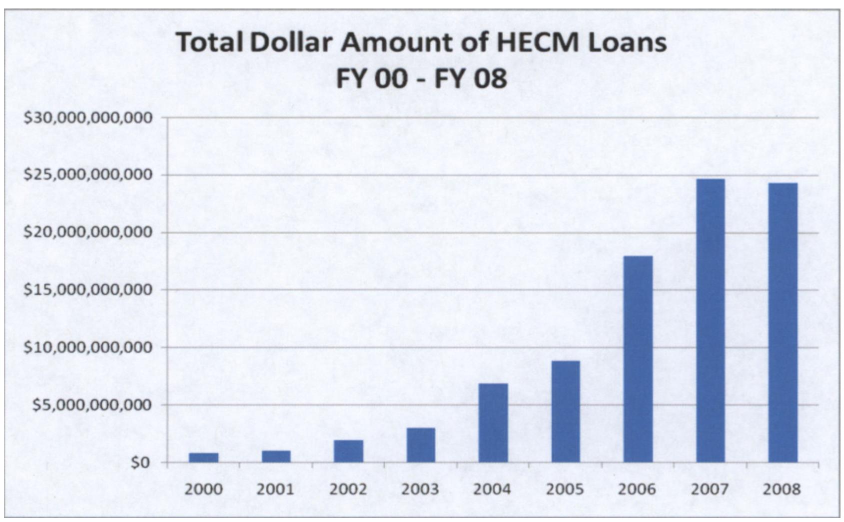
—*Flipping.*—The perpetrator creates a fake mortgage company and "lends" funds to the borrower (no money changes hands, no loan is given, but a mortgage is filed). The subject refinances the borrower into a HECM. At closing the title company pays all outstanding debt including the fraud perpetrators' fake mortgage and the perpetrator walks away with the payoff.

—*Recruitment.*—Some HECM-related fraud activities involve an investor who sells the property to an elderly straw buyer and enters into a quit claim deed with the straw buyer. The buyer applies for the HECM loan within a short timeframe and the appraisal used to originate the HECM loan is then fraudulently inflated. This allows the investor to illegally divert the proceeds of the loan. Straw buyers are "recruited" in residential areas with a high rate of renters. The buyers are often unaware that they must pay property taxes and some are unaware that the cash due to them at closing has been diverted. A current investigation involves recruiting elderly homeless to live in properties victimizing these seniors who often have desperate needs.

—*Annuity.*—Another activity that we currently have under investigation involves financial professionals fraudulently convincing HECM borrowers to invest HECM proceeds in a financial product, such as an annuity, in an improper way. The financial professionals receive increased fees and, in the case of annuities, the victims are unable to get access to their savings for many years or even past their projected life expectancy.

—*Unauthorized Recipient.*—Individual, often family members, may keep HECM payments after the authorized recipient dies or permanently leaves the residence.

HECM loans represent a significant investment by FHA, with considerable recent increases. The chart below shows a 253 percent increase in the dollar amount of HECM loans from 2004 through 2008.



In addition to the schemes described previously, the following case histories also illustrate some of the types of prevalent mortgage fraud that the OIG typically encounters:

—In January 2009, in Philadelphia, Pennsylvania, an appraiser and two settlement agents, were collectively sentenced to 45 months incarceration and 9 years probation and ordered to pay HUD $235,802 in restitution for their earlier guilty pleas to making false statements to HUD and committing a conspiracy and wire and identity fraud. The defendants and others provided fraudulent appraisals and other documents used by unqualified borrowers to obtain FHA-insured mortgages. HUD realized losses of $4,460,588 after 183 mortgages defaulted.

—In September 2008, two defendants in South Florida were charged in a 21 count indictment for their participation in a mortgage fraud scheme that resulted in the approval and disbursement of six mortgage loans totaling $980,000. According to the indictment, one of the defendants, through his company, sold six properties in Miami-Dade County to unqualified buyers using FHA loans. In all six sales, the same defendant, through straw donors, fraudulently financed the down payments and closing costs of the buyers. The second defendant, one of the false donors, was also a silent investor in the scheme. Both defendants allegedly received sizable payments once the properties were sold. When the loans were closed, four of the six properties went into foreclosure.

—An investigation was initiated against a southwest mortgage company. The investigation revealed that the defendant, a real estate broker and owner of an investment company, fraudulently sold 17 properties to undocumented aliens in the Fort Worth, Texas area. The fraudulent FHA loans totaled $1,060,600. The defendant placed false Social Security numbers on the loan applications, inflated loan application figures, made side payment agreements with the borrowers for down payments that, in some cases, were never made and conducted other fraudulent activities. Subsequently, 12 of the 17 loans defaulted and HUD sustained a loss of $445,862. On December 31, 2008, the defendant was sentenced to 37 months in prison, 36 months probation and ordered to pay restitution of $445,862.

—In Rockford, Illinois, a loan officer, realtor, loan processor, and company employers were charged with conspiracy, making false statements to HUD, and mail fraud, in a 35 count indictment. Specifically, the defendants were alleged to have engaged in a complex scheme to defraud HUD through a litany of false and fraudulent statements on FHA loan applications. These included, but were not limited to, the following: verifications of employment, pay stubs, W–2's, credit letters, cashier's checks, Social Security numbers, Social Security cards, and letters containing Social Security Administration letterhead. Overall, 50 FHA loans were in question, with losses totaling in excess of $2 million.

To meet the current crisis, the HUD OIG has initiated a broad range of strategies to leverage available resources including participation in Task Forces [See exhibit]. We are a key partner in the FBI National Mortgage Fraud team and have provided a full-time supervisory special agent to the FBI to coordinate our joint activities. We also sponsor training sessions for the FBI on FHA fraud and participate in special joint operations such as "Operation Malicious Mortgage."

OIG CONCERNS REGARDING CRITICAL FRONT-END AND BACK-END PROCESSES (IMPROVING THE QUALITY OF FHA ORIGINATIONS AND THE ENFORCEMENT OF BAD ACTORS)

To some extent, the FHA has had to work with the hand it was dealt in terms of funding and of industry-led initiatives to diminish its authority. As others have noted, the FHA cannot keep pace with an industry that is increasingly technology driven, and it cannot use its revenues to invest in any new technology. Many of its deficiencies could be mitigated with additional resources dedicated to systems and staffing enhancement. Our audit and investigative work point to critical front-end and back-end process issues that, if strengthened, could enable the FHA to overcome some of its present vulnerabilities.

Appraiser Oversight.—Our work of the FHA appraiser roster identified more critical front-end weaknesses as evidenced in the quality control review and monitoring of the roster. The roster contained unreliable data including the listing of 3,480 appraisers with expired licenses and 199 appraisers that had been State sanctioned. In a further review, we found that HUD's appraiser review process was not adequate to reliably and consistently identify and remedy deficiencies associated with appraisers.

The FHA's current Single-Family insured exposure totals over $560 billion representing 4.8 million FHA-insured mortgages. Inflated appraisals cause higher loan amounts. If the properties foreclose, the loss to the insurance fund is greater. With significant increases in volume and new responsibilities in the mortgage marketplace, we do believe it may be time for the Department to return to an FHA Appraiser Fee Panel similar to the one dismantled by statute in 1994. It is essential if the mortgage industry wants to overcome perceptions regarding its integrity and its role in the current economic crisis that it ensures true market values are correctly estimated. Such a move would relieve pressures on appraisers to return predetermined values and would change a system based on misplaced incentives. A recent study indicated that 90 percent of appraisers felt pressure "to hit the number" provided (i.e., on the sales contract). The old FHA fee panel was rotational and guaranteed work as long as the appraiser met certain HUD requirements.

Our concern that appraisers tied to lenders may impact the quality of the FHA appraisal was also a matter of interest elsewhere as evidenced in last year's settlement involving Fannie Mae and Freddie Mac and the New York Attorney General whereby lenders selling loans to those entities were required to follow stricter guidelines to ensure that people involved in the processing of loans did not also choose the appraiser. While the FHA fee panel was disbanded a number of years ago, the Department of Veterans Affairs has not abandoned this concept and we believe that this Department might want to follow suit thus eliminating the relationship between the loan officers, real estate agents and appraisers. We should remain cognizant that the downstream negative effect of overinflated appraisals is long-term and can be fundamentally corrosive to the housing market and to even, as we know today, the world economy.

Late Payment Endorsement Requirements Changed.—Results from a number of other key audits have noted significant lender underwriting deficiencies, inadequate quality controls, and other operational irregularities. In another important front-end audit, we analyzed the impact of FHA late endorsement policy changes affecting FHA insured loans. On May 17, 2005, the Federal Housing Commissioner issued Mortgagee Letter 2005–23, which significantly changed the requirements for late endorsements for Single-Family insurance. A request for endorsement is considered late whenever the loan binder is received by the FHA more than 60 days after mortgage loan settlement or funds disbursement, whichever is later. The Mortgagee Letter removed the prior 6-month good payment history requirement for these loans and provided an additional 15 days grace period before the current month's payment was considered late.

We conducted a review of this rule change and found that, although FHA asserted the change did not materially increase the insurance risk, FHA did not perform a risk analysis to support this determination. Our review of the performance of loans from seven prior OIG late endorsement audits (i.e., Wells Fargo, National City Mortgage, Cendant, etc.) found a 3½ times higher risk of claims when loans had unacceptable payment histories within the prior 6 months. Since the issuance of the Mortgagee Letter, the default rate for loans submitted late has increased and is significantly higher than the default rate for loans submitted in a timely manner. The HUD Handbook itself acknowledged the risk of unacceptable payment histories by stating 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."

We issued an audit report in 2006 and recommended that HUD rescind the Mortgagee Letter until appropriate rule changes could be designed that were supported by an adequate risk assessment. The FHA disagreed with our audit report and declined to implement the audit recommendations. We referred this matter to HUD's Deputy Secretary who concurred with our recommendations on February 27, 2007 and ordered the FHA to immediately rescind the Mortgagee Letter.

Initially, the FHA agreed to implement the Deputy Secretary's directive but failed to take action, instead taking efforts to dispute our audit results. This continued until April 2008, when the Deputy Secretary's office again intervened, at our request, and instructed the FHA to publish the proposed rule change in the Federal Register reinstating the 6 month payment history requirement for late endorsements. In June 2008, the proposed rule change was published in the Federal Register for comment.

Although the final rule rescinding the Mortgagee Letter was never published, we were notified by the Audit Resolution and Corrective Action Tracking System that the audit recommendation had been closed at the request of the FHA. Indeed it was not implemented, therefore, in a Memorandum dated March 18, 2009, we informed the FHA that, given the amount of time that had lapsed and the absence of a corrective action, the OIG would report this in our next Semi-Annual Report to Congress. Given the current mortgage crisis, concerns over losses to the insurance fund, and requirements for transparency, we believe that this is an important recommendation that should not be dismissed.

Capturing Key Information in, and Upgrading, Data Systems.—Another major input process, touched on earlier in the testimony, is the integration and upgrading of FHA legacy systems. While there has been much discussion on an overall plan, and what particular types of systems are needed to go forward, we think it would be useful at this juncture to reposition the discussion to ascertain which data should actually be collected, and maintained, in the system in order to control the new demands placed on the program. Our audit work and our investigative "Systemic Implication Reports" transmitted to the Department over the years, makes it clear that, at a minimum, we need the system to track identifying information on key individuals involved in the transaction such as the originating loan officer.

This person, for example, is central to the initiation part of the loan process where due diligence should hypothetically be done on the application material (i.e., credit scores, appraisal information, etc.). We would like to see that that person's name and corresponding identifying information (i.e., license, etc.) are put in FHA's data fields. This will allow the FHA and OIG to key in on a vital part of the loan process in which fraud typically can occur. If the system could also capture information on other loan participants such as the real estate agent for the seller and buyer, and other parties to the transaction, that too would be helpful for purposes of increasing integrity in the processes in our investigative and audit functions.

Further, we think it could be beneficial for the FHA to come together more significantly in a unified lender oversight consortium with Fannie Mae, Freddie Mac, the Federal Deposit Insurance Corporation, and Ginnie Mae in order to, among other things, create standardized forms that could produce common machine readable data fields with consistent information as well as to leverage existing data systems.

Additionally, FHA will be challenged within current resource constraints to keep up with the increasing volume of entities doing business. FHA controls currently rely upon random, manual processes by contractors to select for review approximately 2 percent of lender endorsements, a decrease from 5 percent due, in part, to an increase in volume and to funding limitations. FHA then relies upon post-endorsement automated lender or service performance information, such as high delinquency or early default rates, to target these entities for examining a limited number of loans for quality assurance reviews. We believe FHA needs the resources to take advantage of commercial off-the-shelf pre-screening loan software or to require at least the larger lenders use such tools as part of their underwriting process.

Lender Approval Process.—Earlier in this testimony we discussed the increasing number of applicants coming into FHA for lender approval and the abuses that could result. It should be noted that FHA's lender approval process, like the review of loan processes described in the preceding paragraph, is largely manual. The FHA lender approval procedure has different requirements dependent on the type of lender making the application. The general process appears to try to strike a balance between not overburdening the applicant with extraneous requirements with a need for important oversight information. In light of the recent aggressive history of the industry that is now seeking to do business with this Department, we think it may be prudent to review the standards and qualifications for participation. While we are currently auditing this process and will make recommendations when the work is completed, due to the urgent nature of the current circumstances confronting the Nation and this Department from the fallout of the mortgage crisis, we believe some interim steps might need to be assessed.

For example, while the current application contains a certification for those seeking to do business with the Ginnie Mae program that if they knowingly make a false statement in the application, then they may be subject to civil and criminal penalties (18 U.S.C. sections 1001, etc.), there is no such attestation requirement on the application for those seeking to do business with FHA program (See exhibit of Application for Approval to be FHA Lender and accompanying certification statements). Along those lines, we also believe that the FHA should have a criminal background check done on each applicant by seeking to access data systems that contain such information.

Mortgagee Review Board.—As we move to a discussion of essential back-end processes, we note that we have recently initiated a review, at the request of Senator Grassley, of the Mortgagee Review Board (MRB) enforcement actions and its efficiency, effectiveness and impact in resolving cases of serious non-compliance with FHA regulations particularly during this period of significant changes in the housing market. FHA Single-Family endorsements total $71.7 billion in the first quarter of 2009, up 245 percent from the same period a year earlier, emphasizing the need for a strong deterrence to irregular mortgage lending practices. The MRB is a statutorily created board within the Department that has responsibility to sanction FHA-approved lending institutions that violate applicable housing laws and HUD regulations and policies. Established in 1989, it is the sole authorized enforcement body at HUD to remove noncompliant FHA lenders.

Since FHA lending authority is held by more than 12,000 mortgagees and loan correspondents, FHA relies on risk management tools other than the MRB to protect its portfolio and the insurance fund including computerized monitoring of loan default and claim rates, post-endorsement underwriting and appraisal reviews, and on-site lender monitoring. Nevertheless, we believe that a strong deterrence to abusive practices is an effective Board that reaches in a significant way to problematic lenders by, for example, imposing penalties viewed as of real financial consequence to the violating lender, by hearing cases against larger numbers of violators, and by better exposing decisions, in an effort to increase transparency, on more publicly visible sites such as the Department's Web site. Similarly, the Mortgage Bankers Association, in recent testimony, stated that the "FHA should have more aggressive, streamlined and timely processes to expel "bad actors."

Specifically, our review of the MRB will determine the timeliness of decisions; evaluate controls over the mortgagee referral and enforcement processes; summarize data gathered on settlement agreements and collections; and provide an objective basis to comment on the effectiveness of the MRB as a regulatory body. We are looking into issues such as the types of penalties assessed; whether the penalties were mitigated to administrative payments; the sizes of the mortgagees brought before the board; the elapsed time from referral to board action; whether indemnification was required; and whether the mortgagees were repeat offenders or their principals were under limited denial of participations or debarred. We anticipate completion of this review shortly.

OIG CHALLENGES

The task before the HUD OIG is a daunting one: addressing the elements of fraud that were involved in the collapse of the mortgage market; monitoring the roll-out of new FHA loan products in order to reduce exploitation of program vulnerabilities; and, combating perpetrators of fraud, including those who have migrated from the subprime markets, who would exploit FHA loan programs. The consequences of the current mortgage crisis, its worldwide economic implications, and the subsequent pressures placed on the Department and OIG could not have come at a more inopportune time. The Department, as a whole, has had significant new leadership responsibilities over the last 7 years in rebuilding communities devastated by disasters (i.e., lower Manhattan post-September 11th; the gulf coast region after hurricanes Katrina, Rita and Wilma; the Galveston area after recent hurricanes; California fires; and Midwest flooding) that have added tens of billions of dollars in new program funds that require quick distribution and keen oversight. In addition, HUD received over $13.6 billion in the American Recovery and Reinvestment Act that again requires rapid dissemination to an even more widespread area.

While there have been some monies appropriated for salaries and expenses needed for administering all these new programs and the recent passage of the fiscal year 2009 Omnibus Appropriation bill will help, the Department has historically not received analogous increases needed to deal with this new influx of requirements. They, and we, are quite stretched in our combined ability to keep up with the pace of new, critical needs and the changing dynamics of fundamental demands placed on the Department.

Lastly, we would like to note, and emphasize, that we are pleased to be partnering with the FHA in a marketing endeavor to increase the general public's awareness of departmental anti-fraud activities and enhance education through better outreach activities, and to heighten efforts aimed at fraud prevention and at fraud reporting. The HUD OIG is launching a new Web site, www.mortgagefraud.gov, and with the FHA will be using this, as well as other avenues, to better publicize our hotline and activities. Below is the new HUD OIG brand insignia that will accompany our marketing effort to reach the public.

CONCLUSION

As can be deduced from reading through the totality of issues raised in this testimony, a number of cross-cutting concerns transverse many of the highlighted FHA processes. These include: (A) inadequate quality controls; (B) reliance on manual processes; (C) over dependence on the honesty of program participant(s) to provide accurate and truthful information; (D) tendency to focus on entities rather than individuals; and (E) the need to work more with the mortgage industry to better capture data on individuals involved in the process. Further, although not within the control of the FHA, the fact that our nationwide mortgage lending system is fragmented with separate players embracing differing requirements creates opportunities for waste, fraud and abuse that a more unified approach could potentially ameliorate.

In conclusion, though the challenges and tribulations are increasing, the Office of the Inspector General stands ready to assist in whatever way is deemed necessary and will be vigilant in its efforts to protect the funds of the American taxpayer. We thank you for the opportunity to relay our thoughts on these important issues based on the body of our work and of our experience, and greatly appreciate the activities of the Congress to protect the Department's funds from predatory and improper practices and to ensure an effective response on oversight at this critical time.

Senator MURRAY. Thank you.

Mr. Scott.

STATEMENT OF J. LENNOX SCOTT, CHIEF EXECUTIVE OFFICER, JOHN L. SCOTT REAL ESTATE, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

Mr. SCOTT. Thank you, Chairwoman Murray and Ranking Member Bond.

I would like to talk a little bit about what's going on in the housing market. I'm going to refer to my chart quickly about how the housing market is working and the importance of FHA in today's solving the housing crisis. Today I represent the 1.2 million members of the National Association of REALTORS®, myself and my company.

In looking at the chart, the basis, the foundation of the residential housing market is in first-time home buyers coming into the marketplace. Some of them buy new construction, but the majority buys resale homes. So when you bring in first-time home buyers, it causes a chain reaction of sales up the price points.

We break the market into four categories: the first-time home buyer category, the more affordable, the above the midpoint, and the high end. The inventories are always lower in the first-time home buyer category, and they increase as you go up the price points for that.

We have seen an increase in sales activity in first-time home buyer category because of four reasons: the first one being the FHA loans with the flexible credit score. It is allowing more families to come into homeownership, and these are families, individuals or families, who have good credit, that can make the payment.

The next item would be the mortgage interest rates have come down 1 percentage point since last October. This is due mainly in part to the Treasury stepping in to buy mortgage-backed securities. That 1 percent lower on interest rates has created a 12 percent increase in purchasing power.

The other two items that we have that are in fact helping the marketplace are that prices have just been lowered. This past 5 months starting in October, we saw inventory levels raised since October and prices adjusted lower. Even in the first-time home buyer price range, they adjusted the prices 5 percent lower.

Then the last item that we have is that Congress approved and President Obama signed a stimulus package on February 17 that had the $8,000 first-time home buyer tax credit, and buyers were waiting for that tax credit. It came about and they are entering the marketplace.

I'll give you an example of months supply real quick. In Tacoma, Pierce County area, the months supply for existing homes in the first-time buyer category is 4.6 months, around the midpoint is 8 months, above the midpoint is 13.8 months supply, and in the upper end it's 20 months supply. So that just gives you an idea of where the months of inventory is and pricing dictates off the monthly inventory levels.

So we have a low inventory level in the more affordable, in the first-time buyer price range.

Overall, the months supply is 7.2 months supply in Pierce County, Tacoma. Healthy is thought to be in the 5 to 6 months supply range. King County, for example, where Washington is—I mean, where Seattle is, is at an 8.3 months supply.

So we believe FHA is playing a very important role and they can play even a greater role in the recovery of this housing crisis that is taking place. First—there's four points. First, we ask that FHA receive the funding necessary to increase the staff and improve technology. This just expedites the programs and the efficiency and the security of them.

Second, we would like to see the $8,000 first-time buyer tax credit monetized, which means that it's available at the closing table, so that buyers can use that $8,000 for a down payment. I was talking with NAR chief economist Lawrence Hyun yesterday and we are projecting that would bring in an additional 500,000 first-time home buyers into the marketplace. They have good credit. They have the capability to make the payment. It's just that they do not have enough money for the down payment.

That would stimulate the first-time buyer category and cause that chain reaction of sales up the price points. Already we're seeing in many areas of the Nation prices stabilizing in the first-time home buyer category, and this would then stabilize home prices in the more affordable and work its way upward.

They would then pay this $8,000 back from the first-time buyer tax credit, which has already been approved by Congress and signed by the President. This would release pent-up demand.

Also, we'd like to see the higher loan limits made permanent. They are making a difference, especially for move-up buyers, that they could then receive the lower interest rate. Their equities have gone down in this market correction. They need the FHA loans for credit. They have the capability. They're both buying and selling in the same market timing. It's okay to buy and sell at the same market timing in the upper price ranges. They just need the lower interest rates and the credit available to them.

Lastly, ease the financing for condominiums. Right now there is a requirement for an environmental review on a Federal level. We would like to see that the environmental reviews at the State and local level be accepted. This would expedite the process for condominium projects to be able to move forward.

Also we'd like to see that the 51 percent occupancy ratio be lowered to a number below 50 percent for that.

PREPARED STATEMENT

We have submitted our written statement and we'd like to thank you for your support of the Federal housing program. Senator Murray, I'd like to thank you in particular for raising the temporary loan limits up to help us move this market forward during this housing crisis.

[The statement follows:]

PREPARED STATEMENT OF J. LENNOX SCOTT

Chairwoman Murray, Ranking Member Bond, and members of the subcommittee, thank you for inviting me to testify today on the role of the Federal Housing Administration in addressing the housing crisis.

My name is Lennox Scott, and I am the chief executive officer of John L. Scott Real Estate in Bellevue, Washington. I am here today to represent the views of the nearly 1.2 million members of the National Association of REALTORS®, who are involved in every aspect of the real estate business.

The members of the National Association of REALTORS® have had a long tradition of support for innovative and effective Federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure Federal housing programs meet their mission responsibly and efficiently. With the collapse of the private mortgage market, the importance of the Federal Housing Administration has never been more apparent. As liquidity has dried up and underwriting standards have been squeezed tight, the FHA is one of the primary sources of mortgage financing available to families today. Without FHA financing, families would be unable to purchase homes and communities would suffer from continued foreclosure and blight.

In 1934 the Federal Housing Administration was established to provide consumers an alternative during a lending crisis similar to what we face today. At that time, short-term, interest-only and balloon loans were prevalent. FHA was an innovator with the 30-year fixed rate mortgage. Once again, FHA is now the leader in providing safe, affordable financing. The universal and consistent availability of FHA loan products is the principal hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic downturn.

FHA's market share has grown from less than 3 percent to more than 30 percent in a very short time. While this change was necessary to provide a functioning mortgage market, it also provides concern for the safety and soundness of FHA. With such dramatic growth comes increased responsibility, and the need for increased infrastructure and staff.

We believe FHA is doing its best to step up to the challenge. Over the last 18 months, FHA has demonstrated it can handle volume increases at four times 2007 levels while its market share increased to over 30 percent. Despite receiving minimal additional resources, there are two reasons why FHA has been capable of handling the volume. First, once lenders have been approved by FHA, they perform all of the loan processing, underwriting, closing and insuring functions without HUD review. This takes the burden off FHA, although additional oversight in approval may be needed. Second, FHA's technology, despite being 25 years old, remains resilient and fundamentally sound. That said, there are a number of changes that should be implemented to ensure that FHA's Mutual Mortgage Insurance Fund (MMIF) remains strong and healthy.

NEED FOR INCREASED CAPACITY

For years FHA has been hampered by a lack of investment in staff and information technology. The Single Family FHA program currently operates with a nationwide staff of about 900, which is approximately 160 positions less than needed. In addition, FHA operates with technology that is an average of 18 years old. FHA Commissioner Brian Montgomery had said the software programs FHA uses are, in many cases, older than the staff maintaining it. Quickly upgrading the dozens of incompatible systems, such as the 30 year old COBOL system, to web based customer centric applications is necessary for the agency's continued existence and future success.

Our membership believes that FHA cannot continue to serve its constituency without rapidly implementing a quality and systems initiative. Other financial institutions more adequately staffed and with more advanced technology have already gone out of business. It has been estimated that $65 million is required to upgrade the FHA systems and add the appropriate number of staff. These expenditures could save the taxpayer tens of millions of dollars per year and result in a more efficient Government mortgage insurance program.

INCREASED OVERSIGHT/RISK MANAGEMENT

Recent articles have expressed concern about FHA's oversight of loan originators. In order for a lender to be a direct endorser for FHA (and not require HUD approval on every loan), they must submit an application to HUD. The number of applications has skyrocketed in recent months, and we agree with the concerns expressed about both time to process applications and provide the necessary oversight of lenders.

Despite media concern that FHA has become a "dumping ground" for subprime loans and high-risk borrowers, the fiscal year 2008 independent Actuarial Review demonstrates that the FHA Mutual Mortgage Insurance Fund (MMIF) is fiscally sound, and projected to remain so over the next 7 years. While the MMIF has experienced a decline in value, it remains above the congressionally mandated 2 percent capitalization ratio. A high percentage of the decline was the result of falling house prices—something everyone has been facing. In addition, the quality of borrowers utilizing FHA has improved. Borrowers now have higher credit scores and lower loan-to-value ratios; these changes are expected to further improve the financial status of the FHA MMIF.

The Actuarial Review suggests that if current conditions continue, FHA will be able to handle the increased claim activity and decreased valuation of the housing market while meeting its current capital reserve requirements. However, it is important to note that the Actuarial Review is based on July 2008 data, and may not take into account the full impact of actual home value declines since then. The review also does not take into account the latest estimates of anticipated employment decline, which could impact borrower incomes and ability to pay. These factors—higher than expected home price declines and higher than expected unemployment—could present a troubling macroeconomic picture for FHA going forward. While current borrowers' higher credit quality provides some protection from these trends, it cannot eliminate all risks. The most recent data shows that FHA'a delinquency rate is climbing at a troubling rate.

Additional personnel are needed to assure that FHA does not fall victim to fraud or abuse. Recent reports indicate an increase in early payment defaults, i.e those loans that are delinquent with just their first or second payment. Currently monitoring of these loans is limited due to staffing constraints. Increasing lender oversight and staff to monitor fraud and abuse will help keep FHA fiscally strong, and will protect the taxpayers' interest.

TECHNICAL CORRECTIONS TO FHA PROGRAMS

The Housing and Economic Recovery Act (HERA) of 2008, signed into law in July 2008, provided a number of valuable reforms to FHA. However, not all of them have been able to be implemented due to confusion over implementation or interpretation of the law.

HERA included provisions intended to ease financing of condominiums for FHA. However, HUD's attorneys have stated that the legislation does not specifically remove the requirement for an environmental review of the property for a condominium loan to be processed. This review is very time consuming and complicates the home purchase process. Since Congressional intent was to ease financing for condominiums, this matter should be clarified in the law so HUD may implement the new HERA provisions.

Condominiums remain one of the more affordable housing options for American families. NAR further recommends that the FHA reduce the 51 percent occupancy ratio to a number below 50 percent for all condominium developments. Amending the owner-occupancy rules for condominium developments for buyers with FHA mortgages will benefit all parties in the real estate transaction. Individuals and families purchasing condominiums will have access to more flexible and affordable financing opportunities. Potential buyers with FHA mortgages will have a wider choice of condominium developments. Finally, existing owners in these developments benefit as vacant units are purchased and occupied and the owner-occupied ratio increases.

HERA also promoted the use of FHA's energy efficient mortgage (EEM) product. Currently an EEM may include up to $8,000 of energy efficient improvements to a home. However, HERA increased that amount up to 20 percent of the value of the home. FHA has been unable to implement this provision due to a technical flaw in the statute. Given the administrations support of energy efficiency, we urge this technical correction be made to allow borrowers purchasing homes to use FHA to get the full benefit.

Chairman Murray and the subcommittee members have been strong supporters of increasing the FHA loan limits, which was done in both the HERA legislation and in the American Recovery and Reinvestment Act (ARRA) passed earlier this year. ARRA reinstated the 2008 loan limit levels, at 125 percent of local area median home price, capped at $729,750. ARRA also provided the HUD Secretary with discretion to increase the limits in "sub-areas," where home prices may far exceed the county average. However, HUD has chosen not to exercise this authority. We believe the loan limits need to be made permanent at the current levels, as to provide some stability to the market. We also believe that FHA should be encouraged to use their authority to increase the limits in communities that simply have prices higher than their surrounding counties.

FHA AND USE OF THE HOMEBUYER TAX CREDIT

The Housing and Economic Recovery Act of 2008 also includes a first-time homebuyer refundable tax credit up to $7,500 to first-time home buyers for the purchase of a principal residence on or after April 9, 2008 and before July 1, 2009. This was followed by the American Recovery and Reinvestment Act, which offers a tax credit of up to $8,000 for first-time homebuyers who purchase on or after January 1, 2009 and before December 1, 2009.

Enabling homebuyers to have access to their tax credit funds at the time of closing, through a collateralized loan against the tax credit, would allow the home buyer to use the credit toward a down payment. The repayment of the funds borrowed against the credit would be obtained through use of the tax refund. During his confirmation hearings, HUD Secretary Shaun Donovan stated that FHA has the discretion to permit this type of financing mechanism. FHA regulations permit a borrower to use loan proceeds for a home purchase as long as the loan is "secured by property or collateral owned by the borrower independently of the mortgaged property," Loans may be used for a down payment, and secured by the mortgaged property, in certain circumstances and assuming the loan is not provided by a party having a direct or indirect interest in the real estate transaction. This use of the tax credit benefits potential first-time homebuyers with little down payment available for purchase.

Monetizing the tax credit through a loan combined with FHA's low 3.5 percent down payment requirement would offer a strong incentive to buyers who would otherwise not purchase a home this year. NAR estimates that hundreds of thousands of buyers will take advantage of the tax credit. However, proactive use of the tax credit will release even more pent up demand in real estate markets across the country. Granting borrowers access to their tax credit through collateralized loans will further ensure FHA products are the mortgage products of choice for homebuyers.

CONCLUSION

Today's FHA is not your father's FHA. Congress and HUD have made a number of important and valuable changes to FHA over the last several years that have enabled it to stand up to the challenges of today's mortgage market. FHA is now the principal source of financing for millions of American families. Without FHA our economic crisis would be significantly prolonged.

There are a number of reforms that can be made to FHA to ensure its continued success and its availability to hardworking families. We urge the subcommittee to review our proposals and consider using these suggestions to strengthen FHA. We thank you for your continued support of Federal housing programs, and stand ready to work with you to keep these programs viable.

Senator MURRAY. Thank you very much for your excellent testimony.

Ms. Vermillion, we'll go with you.

STATEMENT OF MIA VERMILLION, SENIOR LOAN CONSULTANT, GUILD MORTGAGE, LAKEWOOD, WASHINGTON

Ms. VERMILLION. Madam Chair, distinguished members of the subcommittee——

Senator MURRAY. You want to turn on your mike in front of you.

Ms. VERMILLION. Madam Chair, distinguished members of the subcommittee: I am honored to be here today. I'm glad to assist this subcommittee in any way possible. Please note I am here as a lender, with over 25 years experience, and not a representative of my current employer.

I started originating home loans in Texas and have been in the great State of Washington for the last 9 years. My experience includes a number of HUD products, such as the Tribal 184, but for today we're discussing only the basic FHA fixed rate loan.

As you have pointed out, in Washington State FHA loans went out of favor and have now come back. Many loan originators during 2004 and 2007 had no knowledge of FHA. They'd never done anything that required asset and income verification, so if you didn't have to ask anybody for information it was very simple to close loans. In retrospect, the lower volumes in these bubble years actually benefited the FHA insurance fund by avoiding the losses associated with the revaluation of those assets.

Currently we have a great climate for FHA loans and they are playing a critical role in reviving this real estate market. Thanks in great part to Senator Murray, the increased loan limits have allowed buyers of more expensive homes to benefit from FHA financing. First-time home buyers are out in droves. I usually teach three to four home buyer classes each month following the 5 hour format of the Washington State Housing Finance Commission and our class attendance is sharply up—a good indicator that buyers want to be better informed before committing to a mortgage loan.

Our trade organization I'm sure has let you know that the biggest challenge for FHA lenders relates to warehouse capacity. We have a huge demand for funds and many lenders are struggling to accommodate the volume.

The FHA loan program is a cornerstone of our prudent lending as we move forward. One of my personal concerns is the attempted revival of the seller-funded down payment assistance program. The current down payment for FHA is only 3.5 percent. There are a number of sound down payment assistance programs such as the Washington State Housing Finance Commission offers. The down payment can come from relatives, 401k, or buyers' own funds.

When a seller funnels a down payment to a borrower, we're not only actually doing a zero down loan; in most cases that borrower is paying more as a higher price for that home than they otherwise would.

PREPARED STATEMENT

In conclusion, I hope we all learn from this current housing crisis and do not repeat some of the practices that have led us here. Thank you for your time and attention.

[The statement follows:]

PREPARED STATEMENT OF MIA VERMILLION

I am honored to be here today and glad to assist this subcommittee in any way possible. Please note that I am here as a lender with over 25 years of experience and not as a representative of my current employer. I started originating home loans in Texas and have been in Washington State for the last 9 years. My experience includes a number of HUD products, such as the Tribal 184 loans. For today, I am discussing the basic FHA 30 year fixed rate loan, known as a 203B.

In Texas we experienced a very challenging real estate market in the early 1980s. Fixed interest rates went from 11.5 percent to 18 percent. The market responded with financial innovation and produced many adjustable rate products for conventional loans. Compared to these products, FHA loans often took longer to close and thus fell out of favor in the market. When the overheated real estate market cooled off these conventional loans became very difficult to obtain. At that time, FHA then became the only loan option for buyers who were not VA eligible and did not have the 10–20 percent down payment required for conventional loans.

Moving forward to Washington State, FHA loan endorsements for the most common loan type—the 203B—grew from 15,372 loans in 2000, to 30,766 loans in 2003. After that the number of FHA closed loans dropped to 15,556 in 2004, 8,290 in 2005, 7,707 in 2006 and 8,704 in 2007. Please refer to the attached chart from the HUD site.

WASHINGTON STATE FHA 203B CLOSED LOANS 1990 THRU FEBRUARY 28, 2009

Year	Loans
2009	[1] 6,307
2008	30,500
2007	8,704
2006	7,707
2005	8,290
2004	15,556
2003	30,755
2002	24,162
2001	22,958
2000	15,372
1999	18,657
1998	17,698
1997	14,169
1996	13,175
1995	9,150
1994	22,791
1993	20,704
1992	13,908
1991	16,411
1990	21,183
Total	338,157

[1] Two Months Activity.

Source: HUD.

Many loan originators during 2004–2007 had no knowledge of FHA and had never done anything besides a conventional loan. The market provided varieties of zero down loans, and loans with no proof of income or assets required. These loans not only made it easy for borrowers to qualify, but made it easy for the loan originators. There was just not much work involved when documentation was not necessary. So FHA, requirements for strict borrower income documentation, asset verifications combined with Realtor perceptions that the FHA product was unwieldy, resulted in lower volumes. In retrospect the lower volumes in the "bubble years" has actually benefited the FHA insurance fund by avoiding the losses resulting from the re-valuation of real estate.

And now we have come full cycle again. In 2008 Washington State had 30,500 FHA loans closed. FHA loans are again the best product for both buyers and people trying to refinance—as long as they still have some equity. Conventional loans have additional fees, and mortgage insurance companies are experiencing heavy losses and tightening their guidelines. Loan officers who have never before collected W2s, bank statements, and paystubs are learning we are "back to the basics" in mortgage lending. FHA loans are playing a critical role in reviving this real estate market. In this environment of uncertainty, FHA provides a stable source of liquidity. Thanks in great part to Senator Murray, we now have increased loan limits so buyers of more expensive homes can also benefit from FHA financing.

This is especially true for the first time homebuyers who are benefiting from a combination of lower prices, great interest rates, and the $8,000 tax credit. I usually teach three to four home buyer classes each month, following the 5 hour format of the Washington State Housing Finance Commission. Our class attendance is sharply up, a good indicator that buyers want to be better informed before committing to a mortgage loan.

Mindful of loan quality, most lenders have now implemented minimum FICO scores for their FHA product. These actions will benefit the insurance fund going forward.

As you have heard from our trade organization, the Mortgage Bankers Association, the largest challenge for FHA lenders relates to warehouse capacity. With rates nearing record levels, there is a huge demand for funds. The credit crisis has removed much of the warehouse capacity from the industry and many lenders are struggling to accommodate the volume. This will have a negative effect on consumers as it impacts our ability to continue to make good loans to qualified borrowers, a key element to revive our housing industry.

The FHA loan program is a cornerstone of our prudent lending as we move forward. One of my personal concerns is the attempted revival of the "seller funded down payment." The current down payment for FHA is only 3.5 percent, and there are a number of sound down payment assistance programs such as the Washington State Housing Finance Commission offers. The down payment can also come from relatives, 401k accounts, or a buyer's own funds. When a seller funnels the down payment to a borrower, we are actually not only doing a zero down loan, but in most cases the buyer is paying a higher price for that home than they otherwise could.

In conclusion, I hope we all learn from this current housing crisis and do not repeat some of the practices that have led us here.

Thank you for your time and attention.

Senator MURRAY. Thank you very much.

I appreciate both of you traveling all the way out here from Washington State to lend us your advice and counsel as we move forward to deal with this very important issue. So thank you for being here.

Mr. Donohue, I do want to start with you on questioning. None of us want to see the FHA's portfolio infected with the kind of bad loans that caused the current economic crisis that we're in. Historically, FHA's strong underwriting and programming compliance process has prevented that from happening.

Your testimony and your written testimony explained in great detail the different forms of fraud that can enter into the FHA loan guarantee process. Have your audits shown that there is a significant increase in any of these forms of fraud since the FHA's role started to expand in this current credit crisis?

MORTGAGE FRAUD ACTIVITY

Mr. DONOHUE. Senator, first of all let me thank you and Senator Bond for the support you've given me over the past several years as the IG. I do want to say too that my friend Secretary Donovan—we met regularly and discussed these very issues in a very practical way.

I think the best way to answer this question is that with the increased volume of FHA activity going back on we're seeing an increase in regard to fraud activity. It stands to reason and certainly the FBI and ourselves, have both commented that as the time goes on with the more activity—the way I look at it is to instill as much prevention as you possibly can to ensure that you're doing what you can to prevent that.

I made reference to my easel over here that I think, stating to the effect that when applicants come back into our business at FHA they need to know that if they lie, if they provide false information that they're going to be held accountable to a particular criminal statute.

I think FHA—and I was pleased by the comments of the Secretary as far as being very proactive as far as ensuring the policing of lenders and brokers. I have a host of ideas I've spoken to the Secretary about, and I think my comments mentioned that, such as—my best example of this, Senator, was a matter that came up in your very State, in Seattle, Washington. I couldn't help but notice about a month ago there was an article in the paper about a scam that went on with regard to activity. It mentioned convicts, including embezzlers, robbers, rapists, being involved in mortgage fraud activity.

It was the leadership of the Senate and I believe the State as well to try and police that and make sure it doesn't happen again.

So I think we're trying to, working close with the State and the Federal authorities and DOJ, to make sure we police these activities when we hear about it, and we get information from the Department. They refer cases to us on a regular basis.

Senator MURRAY. Thank you very much.

MAXIMUM LOAN LIMIT

Mr. Scott, in your testimony you talked about the raised loan limits and our support of that. As the law is currently written today, the maximum loan limit is supposed to be adjusted downward by over 100,000 on January 1, 2010. Maybe you and Ms. Vermillion both could comment on what you believe would happen to the market if those higher loan limits are allowed to adjust downward as is currently called for.

Mr. SCOTT. Well, the higher loan limits provide a lower interest rate for borrowers in those price ranges. That increases the purchasing power. It allows them to move forward in their purchases. Especially in the condition where the months supply is so high, it helps get the markets moving in that price category.

Otherwise they're jumping maybe from a conforming loan up to a jumbo loan. The jumbo loan interest rates are higher than the Government-backed loans of FHA. So it is extremely important in the marketplace.

Also, I talked about first-time buyers up 500,000 additional if we can get the money at the closing table. That would equate into a million sales overall because of the chain reaction effect of monetizing the $8,000 first-time home buyer tax credit at the closing table, and that combined—the higher loan limits are a piece of that chain reaction of sales.

Senator MURRAY. Ms. Vermillion, can you comment on that?

Ms. VERMILLION. I agree with that, and I think it's really critical. We have the first-time home buyers out right now because of the combination of low interest rates, lower home prices, and the $8,000 tax credit. So as Mr. Scott has pointed out, that is the very first chain on our chain reaction, and I think the higher limits for FHA are critical to ensure good loans for upper income borrowers.

Senator MURRAY. I expect that you don't expect the current economic crisis to be gone by 2010. That would say we're past this and we need to move on? Do you see that extending out into next year?

Mr. SCOTT. Well, the economics will come forward as they may. But also, the higher loan limits create fairness across the Nation to have access for families to have affordable priced loans. So this—on both coasts and in several areas throughout the Nation, there are higher cost areas, and just making loans accessible.

MORTGAGE RESCUE SCAMS

Senator MURRAY. Are either one of you concerned about an influx of shady lenders and brokers into the FHA program now that the subprime market has disappeared?

Ms. VERMILLION. I am very concerned about that. We're seeing a lot of "mortgage rescue" scams. We're seeing a lot of "loss mitigation" scams. And we are seeing increased fraud in the FHA arena, since that's the primary lending mechanism now. We saw that in Texas back in the 1980s and we're seeing it again.

Senator MURRAY. Okay, thank you very much.

Senator BOND. Thank you, Madam Chair.

A special thanks to our private sector witnesses from Washington traveling here. It really helps to hear your views of the challenges on the ground and providing adequate financing for homeowners. Ms. Vermillion, I appreciate your recognition of the point that I made with Secretary Donovan and he so strongly endorsed, that we don't need any mechanisms that encourage foreclosure. It may not be fraudulent, but they are just in a position to be foreclosed if they don't have enough money to put down a down payment.

DEFAULT/BAILOUT

I turn to our good friend the Inspector General, Mr. Donohue. With this tremendous fivefold increase in business of the FHA, what's your honest assessment that the explosion of FHA authorities and responsibilities might lead to a default or the requirement for a significant bailout from taxpayers, either through what I consider to be a back door way of marking it down as directed spending, taking it out of the budget, appropriating it, or having to recognize it elsewhere on the budget?

What are the risks to taxpayers?

Mr. DONOHUE. Well, Senator, based on my testimony you could see the impact it's had on the FHA MMI fund. It's going the wrong direction. I will state again, as I know you've been an avid supporter of the elimination of selling down. You know how strongly I felt about that.

Senator BOND. We were together on that one.

Mr. DONOHUE. And I'm so pleased to see that end, and so on. But I do think, as it goes—I think the FHA is trying to make some corrective actions. They're working with us. Obviously, if in fact it goes down to the 2 percent margin, then of course they're faced with the very thing that has been raised today, and that's the fact of appropriated funds or an increase in premium. I think that's the only two alternatives that would be placed to ensure the fact that the FHA stays solvent.

Senator BOND. What do you think is the real—are we looking at the potential of a significant taxpayer bailout, given where we are now? Can you assess that?

Mr. DONOHUE. Well, it's hard to say, sir. I think that, based on the numbers we're seeing, I think that it's going to wrong direction by the sheer volume. I think it's something I'd have to take a look at in more detail to comment to you about as far as to the volume. I think with the increased volume certainly is increased premiums. There are actuarial studies that would indicate that it has impacted on this past year.

I see my job, sir, as to try and do everything I possibly can to work with FHA to insure in a proactive way that we prevent any bad activity from coming further into this program as a result of it. But as far as specifics, it's just the pattern we're seeing and the direction its going is not going in the direction which I would like to see and as you would not like to see.

Senator BOND. I would be interested in any further thoughts that you have on needs for FHA staffing. We will be seeing that in the budget, and the IT system.

FHA APPRAISAL PROCESS

But there's a particular area where I think we've seen some really questionable activities. That is in the appraisal process. A good appraisal is essential to make sure that we are not insuring something that isn't worth it. The value of the property has to be accurate. There is always a risk of conflict of interest. I live in a small town. The appraisers are good friends with everybody else.

There is also a danger that appraisers—and I believe that some of the 58 actions that have been brought by the U.S. Attorney for the Eastern District put appraisers in with the mortgage originators.

What kind of steps, what additional steps, should FHA take to make sure that they are getting—that the appraisals are being made by competent people without conflict and on a professional, realistic evaluation of the property?

Mr. DONOHUE. Senator, I think this is a concern that we've shared for some time. The large amount of increase in appraisal activity has drawn the application process. We have seen in our cases and across the country licenses expired. We have seen the absence of good review. As you all know, dating back to 1994 FHA had an appraisal fee panel that used to actually go back and approve FHA appraisals specifically and monitor that number.

I talk to the appraisers as well and of course their challenge is that they're asked to hit the mark, whether it's going down or going up. I think that's of great concern. I couldn't help but notice that the New York Attorney General with FNMA had gone back and expressed a third party resolution to have some uninterested person hire the appraiser involved, and I think it's an interesting notion.

The former general counsel at HUD and I have spoken and he came out of the Mortgage Bankers Association. He expressed to me directly concerns in the ongoing process that appraisals are the thing that we have to look at so very, very carefully.

Finally, sir, the VA itself, which doesn't deal with the volume we deal with, has an appraisal fee program that's still in place and they approve their appraisers on a regular basis.

Senator BOND. Is that something that the FHA should consider?

Mr. DONOHUE. I think they'd have to look at that, sir. They don't certainly do the volume that FHA has done, but I certainly think it's worth taking a look at.

Senator BOND. Thank you very much for your suggestions.

Thank you, Madam Chair.

Senator MURRAY. Thank you.

Mr. Scott and Ms. Vermillion—Ms. Vermillion, you live and work in Pierce County, that's one of the hardest hit areas in our State. Mr. Scott, I know you're familiar with that area as well. I wanted to ask you if there's something particularly there that we should be focused on doing here at the Federal level to help that county.

PIERCE COUNTY

Ms. VERMILLION. Pierce County has been the hardest hit compared to many places in Washington. I believe a great deal of that is due to the economic numbers.

The other thing I would like to see—and I don't know if HUD has the ability to do this; I am assuming they do—is the tracking of foreclosures based on originators or based on sellers. I know we have the notice of deferment—I'm sorry. We debar people if they've been involved. But it was my experience previously that typically if someone is involved in fraud that they don't typically complete one transaction; they typically do multiple transactions.

The other thing that's happened in Pierce County is partly just the economy. We did an FHA loan for a real estate agent, very successful, obviously a full documentation loan, tax returns, et cetera. That person's income has sharply gone down, to the point where she is currently working additional part-time jobs. But she is at risk of losing her home. And that is not something that anybody could have anticipated in retrospect.

Senator MURRAY. Mr. Scott, any comments on that?

Mr. SCOTT. Yes. The Pierce County market changed the year before the Seattle market did, and so the cumulative effects of the years of the economic situation. But as I've pointed out earlier, the months supply in the first-time buyer category has already stabilized and we're seeing renewed activity that will move up the price points.

If we can monetize the $8,000 for an FHA loan at the closing table, that would make a huge impact. If FHA and the IRS could get together and figure that out, that would be just incredible for our Nation to move these programs forward.

We are very excited about having David Stevens as nominee for the head of FHA. The National Realtor Association is very excited about that.

Senator MURRAY. Okay, that's good to know. Thank you very much for that.

HECMS

Mr. Donohue, I wanted to ask you about HECMs. Senator Bond referred to them earlier. They're relatively new, but it is a pretty rapidly growing business for FHA. Those reverse mortgage programs are obviously mostly senior citizens. Can you talk a little bit about any special concerns you might have about HECMs and their potential impact on solvency?

Mr. DONOHUE. I certainly can, Senator. I'm sure you agree this is a very vulnerable population of people with regard to HECMs, from everything from the third party to family participation. We're seeing—we have cases throughout the country that deal with some of these as well. The larger loan limits are certainly going to have a concern with regard to it as to making it attractive to go and pursue these matters.

The other thing we're interested about is the statutory counseling, to make sure they are going back and sitting down with these people and addressing these matters as a primary concern.

We have said—I have met with Senator McCaskill and the Senate Committee on Aging. We have met with the AARP, the Mortgage Bankers Association. They're all concerned about the effect of this program. I think we'd like to see as they go through the process, be it the counselor or the closing agent, to make sure when they see something that's not right to refer those matters to us and address those things rather quickly.

It's a consumer issue that I think, as I said, AARP and they are very much involved with. We're trying to do as much outreach, too, also in letting the communities know how to be on guard with regard to the possibility of this activity.

Senator MURRAY. Thank you.

FHA IMPROVEMENTS

Senator Bond, thank you. I just have one final question to Mr. Scott and Ms. Vermillion. FHA's not been known as the easiest bureaucracy to deal with. You're on the ground out there. Can you tell me your experience? Is it improving, not improving? Does it need improvement? What are you seeing?

Ms. VERMILLION. I'm an FHA fan. I've been working with them for a long time. So when you say it's a bureaucracy, in our level we're originating the loans, we're funding the loans, we're fine.

In terms of going back to the appraisal issue, that has become a concern for a number of appraisers. VA has us use a panel. FHA used to do that and it became so unwieldy it was a problem. I think again if we can address that with monitoring quality that we will be there. But I'm a big fan of FHA loans. I would appreciate them having the additional technology and staff to do what they need to do to keep us going.

Mr. SCOTT. We appreciate the FHA loans. It's making a difference in the marketplace. Of course, the technology enhancements always make a difference.

Senator MURRAY. You both talked about increased staffing, particularly because of the high use right now, too. So I appreciate that.

Mr. SCOTT. Well, it's not only on newly originated transactions, but it would also be refinance activity coming through on top of that, and they will need the staffing.

ADDITIONAL COMMITTEE QUESTIONS

Senator MURRAY. Okay. At this time I will ask the subcommittee members to submit for the record, any additional questions they have for the witnesses.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO HON. SHAUN DONOVAN

QUESTIONS SUBMITTED BY SENATOR PATRICK J. LEAHY

Question. Secretary Donovan, I would like to explore how ongoing issues surrounding HUD and the housing markets are impacting rural areas.

I understand that the Department is working with the Department of Energy on a memorandum of understanding regarding the utilization of weatherization funding from the stimulus. Additionally I understand that it is your intention to make assisted housing automatically eligible for weatherization funds. I believe that this type of coordination is important to ensure that stimulus funds are well utilized, but would like you to clarify what projects will be eligible to receive funding.

As part of this MOU will all types of assisted housing such as section 8, those that have received funds through the HOME, CDBG, and Low Income Housing Tax Credit Programs be automatically eligible for weatherization funds?

Answer. HUD and DOE signed a Memorandum of Understanding on May 6, 2009 aimed at streamlining the use of DOE weatherization funds in HUD-assisted, public housing, and Low Income Housing Tax Credit (LIHTC) multifamily properties. The MOU was aimed primarily at eliminating duplicative income verification requirements which have proved to be a barrier to the use of these funds in these properties in the past. DOE published a Proposed Rule implementing the terms of the MOU in June 2009, solicited public comments, and published a Final Rule on January 25, 2010.

The following projects are generally covered by the new regulation: (1) Public housing; (2) Project-based section 8 assisted housing, section 202 Supportive Housing for the Elderly, section 811 Supportive Housing for Persons with Disabilities; (3) Certain Low Income Housing Tax Credit (LIHTC) properties. Under the terms of the MOU and the DOE rule, HUD will provide DOE with a list of properties in these categories where at least two-thirds of their residents meet the DOE income requirement (200 percent below poverty) for weatherization assistance. Properties identified by HUD that appear on this list will not be required to provide independent income verification, but will automatically meet the DOE income eligibility requirements.

Due to lack of available data, several programs are not specifically covered by the rule: section 221(d)3 and d(5), and section 236 Below Market Interest Rate properties, as well as Indian housing, unless they fall into one of the three categories noted above. Section 8 tenant-based rental vouchers are also not addressed. However, any of these programs will continue to be eligible for weatherization assistance through normal DOE procedures.

Please note that it is not entirely accurate to say that the MOU and subsequent DOE Rule would make assisted housing "automatically eligible for weatherization funds"—it is still up to individual States and local weatherization providers to allocate these funds to individual properties, according to local preferences and priorities and as outlined in each State's weatherization plan. Nothing in the Final Rule overrides these State prerogatives. Most States have focused their resources on single-family housing; the DOE regulation will streamline procedures for verifying rental incomes in those States and/or for those local weatherization providers who wish to allocate funds for multifamily weatherization assistance.

Question. The Neighborhood Stabilization Program has helped many communities around the country address their redevelopment needs. However for many rural States, conditions other than foreclosures have led to distressed housing markets. I believe that this program should be more flexible in order to support addressing the diverse issues facing in our housing markets.

Would the Department be open to modifying or waiving the established targeting areas for States receiving the minimum allocation under this program? Further, would the Department support counting the redevelopment of demolished, vacant or blighted properties toward the requirement that 25 percent of the NSP units serve very low income families? And, for State's like Vermont that have not received adequate counseling assistance due to relatively low foreclosure rates, but still facing the skyrocketing foreclosure crisis, will the Department allow at least 10 percent of a State's allocation of NSP funds to be used for foreclosure counseling and prevention activities?

Answer. With regard to expanding target areas for States with minimum Neighborhood Stabilization Program (NSP) allocations, a provision in Public Law 111–22 authorized HUD to permit qualifying States to expand their target areas and is in the process of issuing guidance to implement this provision. With regard to properties eligible to meet the requirement that 25 percent of NSP funds be expended to provide housing to households at or below 50 percent of area median income, HUD is constrained by the NSP authorizing language in the Housing and Economic Recovery Act of 2008 (HERA) which specifically states that only abandoned or foreclosed properties can qualify as meeting this low income benefit requirement. Finally, HERA defines the eligible uses of NSP funds and foreclosure counseling is included as not an eligible use. HUD has, however, permitted the use of NSP funds to pay for housing counseling when it is associated with the purchase of a property assisted with NSP funds.

Question. Due to the frozen credit markets, Housing Finance Agencies (HFAs) cannot find investors for their mortgage revenue bonds or liquidity providers to back their bonds. As a result, more than 30 housing finance agencies across the country are being forced to suspend or limit their mortgage lending programs. Among the housing recovery plans announced by the administration at the beginning of March, support for HFAs was among these plans.

What specific steps are the Department and administration going to take to improve liquidity for State HFAs and when will this action be taken?

Answer. On October 19, the administration announced a new initiative to provide critically needed assistance to State and local HFAs to help support low mortgage rates and expand resources for low and middle income borrowers to purchase or rent homes that are affordable over the long term. Following up on the intent to support HFAs first outlined in February under the Homeowner Affordability and Stability Plan, the administration's initiative has two parts: a New Issue Bond Program (NIBP) to support new lending by HFAs and a Temporary Credit and Liquidity Program (TCLP) to improve the access of HFAs to liquidity for outstanding HFA bonds.

THE NEW ISSUE BOND PROGRAM (NIBP)

The New Issue Bond Program (NIBP) provided temporary financing for HFAs to issue new housing bonds. Treasury purchased securities of Fannie Mae and Freddie Mac backed by these new housing bonds. With these investments, the HFAs have issued an amount of new housing bonds equal to what they are authorized to issue with the allocations provided them by Congress but have been unable to issue given the current challenges in housing and related markets. The program may support up to several hundred thousand new mortgages to first time home buyers this coming year, as well as refinancing opportunities to put at-risk, but responsible and performing, borrowers into more sustainable mortgages. The NIBP will also support development of tens of thousands of new rental housing units for working families.

THE TEMPORARY CREDIT AND LIQUIDITY PROGRAM (TCLP)

Fannie Mae and Freddie Mac are administering a Temporary Credit and Liquidity Program (TCLP) for HFAs to help relieve current financial strains and enable them to continue to serve their important role in providing housing resources to working families. Treasury has agreed to purchase a participation interest in the Temporary Credit and Liquidity Facilities (TCLFs) provided to HFAs under the program, providing a credit and liquidity backstop. The TCLP provides HFAs with temporary credit and liquidity facilities to help the HFAs maintain their financial health and preserve the viability of the HFA infrastructure so that HFAs can continue their Congressionally supported role in helping provide affordable mortgage credit to low and moderate income Americans, as well as continue their other important activities in communities.

On January 13, the administration announced the completion of all transactions under the State and local Housing Finance Agency (HFA) Initiative, With these transactions, the Obama administration helps support low mortgage rates and expands resources for low and middle income borrowers to purchase or rent homes that are affordable over the long term.

Over 90 State and local HFAs representing 49 States participated in the NIBP for an aggregate total new issuance of $15.3 billion. Twelve HFAs participated in the TCLP for an aggregate total usage of $8.2 billion. The Initiative is expected to come at no cost to the taxpayers and to the Government Sponsored Enterprises.

Question. With more and more Americans facing eviction and the threat of homelessness, the already-long waiting lists for section 8 vouchers continues to swell. In Vermont, the Vermont State Housing Authority has intermittently had to close the wait list and it has been thousands of people long at different times—a wait of several years for assistance finding a safe and affordable place to live.

What does the Department plan to do about the increasing demand for rental assistance? Will you support the creation of additional vouchers?

Answer. The housing choice voucher program is HUD's largest affordable housing program, which currently assists over 2 million families. Under the fiscal year 2010 Appropriations Act, HUD received $75 million in new vouchers for the Veterans Affairs Supportive Housing (VASH) program, which targets voucher rental assistance and supportive services to homeless veterans. HUD also received $15 million in new vouchers for the Family Unification Program (FUP), which provides rental assistance to families for whom the lack of adequate housing is a primary factor in the separation of a child from their family. In addition, HUD received $150 million in new voucher assistance for tenant protection activities such as public housing demolition and disposition.

HUD recognizes that long waiting lists are common in many areas of the country. While vouchers are a vital component in addressing that need, additional funding requests cannot adversely impact funding needs for other critical HUD programs and initiatives. HUD is seeking to expand affordable housing opportunities for families not only through the use of tenant-based rental assistance but also by increasing affordable housing production and preserving existing housing stock.

QUESTION SUBMITTED BY SENATOR FRANK R. LAUTENBERG

Question. In the wake of the credit crisis, the New Jersey Housing and Mortgage Finance Agency—along with housing and finance agencies around the country—is having trouble finding agencies that will insure loans for homes designated for low-income homeowners. I understand that, under current policy, the Federal Housing Administration (FHA) does not insure mortgage loans made to purchasers of income-restricted housing. New Jersey currently has a surplus of vacant affordable housing because prospective home buyers cannot find an agency to insure their loan.

Will the FHA consider changing its policy so it can start insuring loans on properties that are restricted for low- and moderate-income homeowners?

Answer. FHA does not permit any form of "resale" restriction as a general practice, any type of requirement that would prevent a home from being sold on the open market to any buyer. However, when resale restrictions are established as part of a specialized affordable homeownership program, the FHA does have regulatory authority to permit these types of arrangements. We would be happy to work with the New Jersey Housing and Mortgage Finance Agency to ensure that FHA financing is available to home buyers purchasing homes that are part of the agency's program.

QUESTION SUBMITTED BY SENATOR SAM BROWNBACK

Question. Secretary Donovan, most economists agree that the housing market continues to be the primary concern for the economy. Part of solving that is decreasing the amount of housing stock available. To assist in that, Congress included a first-time home buyer tax credit in legislation last year and then increased and extended the tax credit in this year's stimulus legislation. Unfortunately, the tax credit can only be effective in helping individuals get into homes if it can be utilized up-front. I understand there is confusion in the marketplace as to whether that tax credit can be monetized and used at closing for downpayment and closing costs. In a response to a question from my colleague, Senator Corker, I'm told that you stated that the Federal Housing Administration (FHA) has the "discretion" to allow for the tax credit to be monetized (under certain specific provisions of FHA's underwriting guidelines). However, I also understand that some lenders are having trouble receiving clear guidance from HUD as to whether the tax credit can be used as collateral to obtain a loan for down payment and closing costs at closing.

Can you provide clarity and certainty as to whether this can be allowed?

Answer. FHA will not permit the home buyer tax credit to be monetized and used to meet the borrower's downpayment, which is also referred to as FHA's statutory 3.5 percent minimum cash investment requirement. However, an advance on the credit (or monetization) may be used to help cover the borrower's closing costs.

QUESTIONS SUBMITTED BY SENATOR GEORGE V. VOINOVICH

Question. At HUD and the FHA, do you have the human capital needed to responsibly approve new lenders doing business with the FHA?

Answer. Yes. FHA's monthly average number of entities requesting approval as an FHA lender has decreased from 396 in fiscal year 2008, to 215 in fiscal year 2009, to 154 for fiscal year 2010 to date. In addition, turnaround time for applications that meet all of FHA requirements during the first review is within the 30-day standard set by FHA's Lender Approval Division. FHA is working to obtain the necessary system and contracting dollars needed to comply with the additional eligibility standards for approval as an FHA lender in the "Helping Families Save Their Homes Act of 2009" (Public Law 111–22).

Question. Do you have the human capital to investigate the potential abuse by lenders misleading homeowners?

Answer. This question is very general and thus it is difficult to provide a comprehensive response. FHA and HUD have a myriad of responsibilities and consumer protections built into its various programs. For instance, Housing's Office of Regulatory Affairs and Manufactured Housing is equipped to enforce violations under the Real Estate Settlement Procedures Act (RESPA). HUD's Office of Fair Housing and Equal Opportunity (FHEO) is equipped to investigate violations of Fair Housing laws. Within FHA, approved lenders serve as the financial intermediary between FHA and the homeowner. Consequently, FHA does not receive a great deal of direct consumer complaints regarding potential abuses by lenders. Nonetheless, FHA does pay particular attention to any complaint regarding abuses within its loan programs. FHA uses a rigorous nationwide Quality Assurance program to monitor lender performance and compliance with its program rules and regulations. As an element of its risk-based lender targeting, FHA incorporates complaints received on abusive or misleading lending practices. Any instances of consumer abuse discovered during FHA lender reviews are addressed via administrative action through FHA's Mortgagee Review Board. All instances of potential fraud and/or criminal activity are referred to HUD's Office of Inspector General for investigation.

Question. What training is provided for new FHA lenders regarding FHA loan guidelines? Who ensures that FHA loan guidelines are being carried out, such as agency rules requiring borrowers to document their income, down payment requirement, and a time commitment to living in the home?

Answer. FHA is constantly monitoring lender performance and loan level compliance from the moment a lender is approved to originate and/or service FHA loans, and from the instant a loan is originated. Lender applications for FHA approval undergo an evaluation of: (1) the company's financial capacity/resources; (2) its possession of appropriate State licensing; (3) the eligibility of the company and its principals, owners and officers to participate in Government programs; and (4) the company's quality control and compliance plans and procedures. Once approved, lenders recertify annually to ensure continued adherence to FHA requirements. Moreover, if a lender wishes to gain Direct Endorsement approval, it must undergo a "Test Case" evaluation, which helps FHA assess the lender's knowledge of and adherence to FHA underwriting guidelines.

After ensuring that a lender meets all approval requirements, FHA switches the focus of its monitoring activities to the loans underwritten by a lender. All loans are required to pass certain checks prior to insurance endorsement, including but not limited to, verifications of borrower identity, confirmation that borrowers do not possess outstanding obligations to the Government, and certification that borrowers have not participated in property flipping activities. Following endorsement of a loan, FHA staff conducts Post Endorsement Technical Reviews (PETRs), emphasizing compliance with FHA requirements to ensure that loans do not pose a risk to the FHA insurance fund.

FHA's Quality Assurance Division (QAD) also administers the Credit Watch Termination Initiative, which identifies underwriting lenders and originators whose default and claim rates are deemed excessive relative to other lenders in the same HUD Field Office Jurisdiction. Additionally, Headquarters QAD is responsible for the Neighborhood Watch Early Warning System, which is used to monitor lender and servicer performance by FHA staff, lenders, and other stakeholders. Utilizing Neighborhood Watch to assess risk indicators and default rates, FHA staff target lenders for on-site review by QAD Divisions that are based in field offices throughout the country.

QAD offices located in the field conduct HUD Lender Monitoring Reviews that include on-site loan level review of lender files, and a review of lenders' compliance with FHA program requirements. FHA's review of loans continues throughout the life of the loan.

FHA's National Servicing Center conducts an analysis of lenders' participation in loss mitigation, which identifies those lenders in need of additional training from the NSC, as well as those that should be considered for a lender monitoring review or possible investigation.

During the course of quality assurance reviews, HUD staff identify potential evidence of fraud and refer those findings to the HUD OIG. Additionally, evidence of program violations is referred to the Enforcement Center and/or the Mortgagee Review Board for possible administrative action.

The Mortgagee Review Board may take the following administrative actions against mortgagees and lenders: withdrawal, suspension, probation, letter of reprimand, and cease and desist. The Board also has the power to impose civil money penalties as well as enter into settlement agreements. It is only by settlement agreement that the Board can obtain an indemnification agreement. The Board does not have statutory authority to require indemnification.

As stated above, the Board can penalize FHA lenders and mortgagees for material violations of HUD requirements and may also enter into settlement agreements.

Question. Why is the participation rate for the Home for Homeowners program so low when foreclosure rates continue to increase? What can be done to improve the Hope for Homeowners program to increase participation?

Answer. HOPE for Homeowners (H4H) was initially authorized under the Housing and Economic Recovery Act of 2008 to provide a mechanism to help distressed homeowners refinance into FHA insured loans. Unfortunately, due to several obstacles to participation, including steep borrower fees and costs, complex program requirements, and lack of operational flexibility in program design, the original program only assisted a small number of homeowners.

The administration has taken a number of steps to improve the uptake for the program. On April 28, 2009, the administration announced steps to incorporate H4H into the Making Home Affordable program. In addition, on May 20, 2009, the President signed the "Helping Families Save Their Homes Act of 2009" which provided improved program features. The legislation eases eligibility requirements and streamlined the application process for the HOPE for Homeowners program.

Guidance for the improved H4H program was issued in October and went into effect on January 1. However, there are some continuing challenges to maximizing program uptake. Because of legislative language mandating certain underwriting features for the program, servicers must modify their underwriting systems. In addition, the underwriting features also raise questions about the pricing of H4H MBS in market place. The administration is pursuing regulatory and legislative changes to increase the number of at-risk borrowers who can benefit from the program.

Question. How does the Obama administration's foreclosure plan—"Making Home Affordable" coordinate with Home for Homeowners to help families refinance into more affordable loans?

Answer. As mentioned above, the H4H program has been integrated into the administration's comprehensive approach to stabilizing the housing markets—the Making Home Affordable program. When a borrower approaches a participating MHA servicers for assistance, the servicer is required to offer the option for a H4H refinancing in tandem with the MHA trial modification option. To ensure proper alignment of incentives, servicers and lenders will receive pay-for-success payments for H4H refinancing similar to those offered for Home Affordable Modifications. The Home Affordable Modification program is intended to bring stability to the housing market and help American families reduce their monthly mortgage payments. The revised H4H program is intended to help homeowners whose loans are not owned or securitized by Fannie Mae or Freddie Mac, who are behind on their payments, who owe far more than they are worth, and who may find that modifying the terms of their loans is not a workable solution. The program would assist homeowners by taking into consideration their ability to pay and making their mortgage sustainable over the long haul.

Question. In my hometown of Cleveland, the foreclosure crisis has ripped through like a tornado. I have supported the Neighborhood Stabilization Program (NSP) created last summer to provide local communities resources to address vacant, abandoned, and foreclosed properties. Recently, it has been brought to my attention that HUD is selling condemned HUD-owned properties to the city of Cleveland for the city to use its limited NSP resources to demolish the home. Can you please explain to me why HUD cannot use its own resources to demolish the homes they should have taken care of in the first place?

Answer. On average, the Department annually acquires approximately 50,000 single family properties from HUD-approved lenders. To ensure that such properties are properly secured, maintained, and marketed for sale, HUD uses Management and Marketing (M&M) Contractors. These contractors are required to appraise HUD-owned properties using FHA Roster Appraisers, establish the list price for such properties, and market and sell properties for the maximum price the market will bear. The Department uses this disposition strategy as it is necessary to replenish the Mutual Mortgage Insurance Fund and is the most effective way for FHA to generate proceeds to provide home buyers an affordable loan financing alternative to conventional and subprime loans.

Thus, HUD does not require its contractors to simply demolish its properties based on their appraised value. Instead, the conditions of the real estate markets are also factored in the contractors' determination of the ultimate disposition or sale of a property. In markets such as Cleveland, for example, "hard to sell" properties are offered to local governments at deep discounts to further the Department's affordable housing and neighborhood stabilization objectives. In addition, to the extent that the Department is aware of a HUD-owned property being condemned or due to receive a Notice of Condemnation, HUD's contractors have been directed to disclose this information to all potential purchasers of HUD homes.

Lastly, the Department, via its Neighborhood Stabilization Program (NSP), has awarded the city of Cleveland more than $16 million to address its high rate of foreclosed, abandoned properties, which contribute to blight within many of Cleveland's neighborhoods. Under the NSP program, local governments may acquire, demolish and rebuild, or rehabilitate foreclosed properties using NSP Federal grant funds. Additionally, to assist local governments in combating blight and in maximizing their use of the NSP grant funds, the Department is offering HUD-owned foreclosed properties valued at $20,000 or less (i.e., those considered to be "demolition properties") for $100. Specifically, 211 HUD-owned properties have been held off the market by the Department, pending a direct sale to the city of Cleveland. Many of these 211 homes are valued at $20,000 or less, with a collective value of $2,105,200.

Question. Secretary Donovan, in a previous meeting I gave you a list of recommended modifications to the Neighborhood Stabilization Program supported by the "National Foreclosure Prevention and Neighborhood Stabilization Task Force." What is the status of the proposed regulatory modifications for NSP?

Answer. The Department implemented several regulatory changes for NSP in a notice issue in June 2009. These changes reduced the required purchase discount for NSP properties to 1 percent and eliminated the overall portfolio discount requirement. HUD also reduced appraisal requirements associated with properties having value below $25,000. The notice also implemented several statutory amendments made to NSP by the American Recovery and Reinvestment Act of 2009, most notably the repeal of NSP revenue provision. This enabled HUD to implement program income provisions for NSP that parallel the program income requirements of the Community Development Block Grant program. The Department is committed to working closely with its NSP grantees to address and resolve programmatic issues that arise in the implementation of the program.

Senator MURRAY. Well, I'd like to thank all of our witnesses today, especially for keeping your testimony tight, as we are in budget mode here and have a number of amendments that we'll start voting on shortly. But thank you again to both of our Washington State folks for coming out here. To all the FHA and to Mr. Donohue, we appreciate your testimony.

CONCLUSION OF HEARING

At this time the subcommittee will be recessed subject to the call of the Chair.

[Whereupon, at 11:25 a.m., Thursday, April 2, the hearing was concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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